PRACTICAL COMPLETION AND LIQUIDATED DAMAGES IN CONSTRUCTION CONTRACTS

LAI SZE CHING

FAKULTI UNDANG-UNDANG
UNIVERSITI MALAYA

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LAI SZE CHING

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Name of Candidate: LAI SZE CHING (I.C/Passport No: 540710-05-5347)

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Designation: Fakulti Undang-Undang
Universiti Malaya
50603 Kuala Lumpur

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ABSTRACT

Practical Completion is a term widely used in construction contract to denote completion of works by the contractor. However, it is unfortunate that there is no firm legally defined meaning for the term. The courts have adopted different approaches to define it; nonetheless there is no single view that is acceptable universally by the courts. This has caused uncertainty and difficulties to the contracting parties. When a project is delayed in completion, the employer will be entitled to damages caused by the delay. It is common for construction contracts to incorporate a pre-agreed liquidated damages clause whereby the employer is allowed to claim damages based on the rate stipulated in the contract without having to prove actual losses. In Malaysia, the governing statutory provision is section 75 Contracts Act 1950 and the Federal Court in *Selva Kumar* had decided that the employer must prove the damages suffered notwithstanding the clear wordings in section 75. Again this has created some difficulties as this seems to defeats the very purpose of agreeing to a liquidated damages clause. This research will attempt to provide some guidance on what is the most sensible definition of practical completion and also the ways to circumvent the rigor of *Selva Kumar*.

ABSTRAK

Penyiapan Praktikal adalah satu terma yang digunakan dalam industri pembinaan dan kebanyakan borang kontrak standard membuat rujukan kepada penyiapan kerja oleh kontraktor. Namun, maksud penyiapan praktikal dari segi undang-undang masih belum dapat diputuskan. Tidak susah didapati bahawa keputusan-keputusan makhamah diasaskan pada pelbagi interpretasi dalam usaha pendefinasian terma penyiapan practical; namun, sehingga ke tahap kini, industri pembinaan masih kekurangan satu definasi perundanga sebenar penyiapan praktikal yang dapat diterima secara umum. Ini menyebabkan industri pembinaan menghadapi situasi yang tidak jelas dan masalah-masalah tertentu. Apabila sesuatu projek mengalami kelewatan disebabakan kegagalan contractor, majikan diberi hak untuk menuntut gantirugi di atas kerugian yang disebabkan oleh kegagalan tersebut. Untuk tujuan ini, adalah satu kebiasaan untuk pihak-pihak kontrak untuk memasukkan klausa Ganti Rugi Tertentu (Liquidated Damages Clause) yang akan membolehkan klien membuat tuntutan berdasarkan kadar yang dipersetujui tanpa perlu membuktikan kepada kontraktor kerugian yang dialaminya. Di Malaysia, isu-isu tentang pengenaan Ganti Rugi Tertentu dikawal oleh seksyen 75 Akta Kontrak 1950 dan keputusan makhamah dalam kes Selva Kumar dimana makhamah memutuskan bahawa klien dikehendaki untuk membuktikan kerugian walaupun adalah jelas daripada seksyen 75 Akta Kontrak tentang ketidakperluan ini. Keputusan ini telah menimbulkan kekeliruan memandangkan ianya jelas menyebabkan tujuan sebenar pihak-pihak kontrak memasukkan klausa tersebut tidak dapat dicapai. Kertas penyelidikan ini dijalankan untuk memberi garispanduan dalam mengenalpasti maksud perundangan penyiapan praktikal yang paling munasabah dan sejauh manakah pihak-pihak kontrak dapat mengelak daripada masalah yang ditimbulkan oleh *Selva Kumar*.

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LIST OF CASES

LIST OF ABBREVIATIONS

AC	-	Law Reports Appeal Cases Series
AIR	-	All India Reports
All ER	-	All England Law Reports
BLR	-	Building Law Reports
Ch D	-	Chancery Division (Law Reports)
CIDB	-	Construction Industry Development Board
CILL	-	Construction Industry Law Letter
CLJ	-	Current Law Journal
CLR	-	Commonwealth Law Reports
Con LR	-	Construction Law Reports
Const LJ	-	Construction Law Journal
DLR	-	Dominion Law Report, Canada
EWCA	-	England and Wales Court of Appeal Cases
EWHC	-	England and Wales High Court Cases
Exch	-	Exchequer Reports
FIDIC	-	Federacion Internacional De Ingenieros Consoltores
FMSLR	-	Federated Malay States Law Reports
Giff	-	Giffard's Reports
ICE	-	Institute of Civil Engineering
IEM	-	Institute of Engineers Malaysia
ILT	-	Irish Law Times
JKR	-	Jabatan Kerja Raya
Jur NS	-	Jurist New Series, NZ
KB (or QB)	-	King's (or Queen's) Bench

LGR	-	Local Government Review
Lloyd's Rep	-	Lloyd's List Law Reports
LNS	-	Legal Network Series
LT	-	Law Times
MLJ	-	Malayan Law Journal
NBR	-	New Brunswick Report, New Brunswick
NSWLR	-	New South Wales Law Report, Australia
NZLR	-	New Zealand Law Reports, NZ
PAM	-	Pertubuhan Arkitek Malaysia
PC	-	Privy Council
TCC	-	Technology and Construction Court
TLR	-	Times Law Reports
VR	-	Victoria Law Reports
WLR	-	Weekly Law Reports

CHAPTER 1

INTRODUCTION

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INTRODUCTION

1. Background of Studies

Construction of engineering works is normally complex and involves interaction between multi-parties and it attracts large volume of diverse disputes. Two areas of construction that have attracted considerable controversies are what amounts to completion of a project and what is the law on the liquidated damages liable by the contractor if the project is delayed in completion.

The law and practices in relation to the completion of building and engineering projects is complex and the courts have adopted different judicial approaches in deciding whether a project is 'completed'.

In most of the standard forms for construction contract, the term 'practical completion' or 'substantial completion' is used to denote completion of the works by the contractor. Practical completion of the works is introduced into the standard forms of construction contract in order to distinguish from that of 'final completion'. This distinction allows for minor outstanding or defective work, which do not affect the enjoyment or utilization of the facility to be completed or rectified notwithstanding that the employer has taken over and started to use the facility.

When a project is completed late, the usual redress afforded to the employer is to seek monetary compensation for the loss suffered. Due to nature of construction contracts in which the loss is difficult to be measured, most standard forms will incorporate liquidated damages clause in the contract. Liquidated damages, as a provision in a contract and therefore agreed between the parties to the contract at the time of entering into it, aim to determine in advance the extent of the liability when the works is delayed in completion. A typical liquidated damages clause will normally provides that if the contractor fails to complete the work by the agreed completion date, he will be required to pay the owner a stipulated amount for each day thereafter until completion.

2. Problem Statement

Most of the standard forms for construction contracts used internationally do not define the term "completion" or "practical completion" of the works. This uncertainty has posed problems to the construction industry as one of the important effects as to completion is the operability of a liquidated damages clause.

The term "practical completion" in construction contract has been used extensively for a long period of time and it is remarkable that, in view of the frequent occasions upon which it is the subject of dispute, it still has no firm legally defined meaning.

When the work is alleged by the contractor to have been completed, a question will arise: "are the works practically completed?" As the word "practical completion" is not defined in the contract, the question on 'whether or not the works are practically completed" is a matter of the opinion of the contract administrator. The courts have also adopted different approaches in determination on this issue.

Therefore, it is obvious that it would serve the parties better if an unambiguous definition is provided, either in the contract of by the court.

When a project is not practically completed on the agreed date, the employer will be entitled to recover damages for the loss suffered. For most standard forms of construction contract, an agreed provision for liquidated damages is normally included in the contract which stipulates damages to be paid for each day of delay in completing the works. The main purpose of agreeing on such a clause is to avoid the difficulty of proving the loss. However, when the works is delayed the contractor will normally challenge the enforceability of such liquidated damages clause, notwithstanding that this has been mutually agreed when parties entered into the contract.

Under the common law, the court will distinguish a genuine liquidated damages clause, which is enforceable, and a penalty, which is unenforceable. If the clause is held to be a penalty, then the employer has to prove his actual loss and to sue for unliquidated or general damages.

In Malaysia, the court has interpreted section 75 of the Contracts Act 1950 in restricted manner in which the employer is required to prove his actual losses if the damages can be measured by settled rules. This will undoubtedly impose a heavy burden to the employer and it also defeats the very purpose of agreeing on a liquidated damages clause. This has also impugned the doctrine of freedom of contract; which is an important aspect of commercial agreements and free market economy.

3. Objective of the Study

The objectives of the study are as follows:

(a) To determine legal meaning of practical completion based on cases of law

(b) To determine the definition used in some standard forms of contract used in Malaysia

(c) To determine the law on liquidated damages and the necessity to prove losses

(d) To develop measures to circumvent the rigor of section 75 Contracts Acts 1950 and the case of *Selva Kumar.*

4. Significance of the Study

The findings of this study will determine the preferred legal meaning of practical completion of works. The unambiguous definition provided in a contract will undoubtedly assist the contracting parties to understand their rights and obligations relating to completion of work. This will avoid unnecessary disputes and lengthy litigation later.

The provision of liquidated damages in a building contract will allow the employer to recover the losses simpliciter when the work is delayed. However if the liquidated damages clause is successfully challenged in the courts, this will place the employer in an unfovourable position as he is now required to prove the actual losses.

Therefore this study will provide guidance to contracting parties as to their rights to the damages when a liquidated damages clause is stipulated in the contract. The study also suggests some possible ways to circumvent section 75 Contracts Act 1950 and the case of *Selva Kumar.*

5. Scope and Limitation of the Study

The study will focus on the following issues:

(a) Courts' decisions in defining the term of "practical completion".

(b) The definition of "practical completion" adopted in standard forms of contract commonly used in Malaysia, namely PAM, CIDB, IEM and JKR 203A.

(c) General law on liquidated damages.

(d) Governing law on liquidated damages in Malaysia and decided cases.

(e) Ways to circumvent section 75 Contracts Act 1950 and the case of *Selva Kumar*.

6. Research Methodology

A systematic of research process or approach has been adopted to achieve the objective of the study. Generally, this research process covers five stages:

(a) Identifying the research issue

(b) Literature review

(c) Data and information collection

(d) Research analysis

(e) Conclusion and recommendations.

Identifying the research issue is the initial stage of the whole research. To identify the issue, firstly, it involves reading various sources of published materials, such as case reports, journals, articles, seminar papers, previous research papers or other related research papers, newspapers, magazine and electronic resources as well through the

World Wide Web and online e-databases from Universiti Malaya. Based on the research issue, the objective and scope of the study is identified.

Literature review is the second stage of the research. This will involve the collection of documents which form secondary data for the research, such as text books, case reports and journals, newspapers. Indeed, published resources such as case reports, journals, standard forms of contract and related legislations are most helpful in this literature review stage. Reported cases from different sources such as Malayan Law Journal, All England Report, All India Reports, Building Law Reports etc will be studied during this stage.

Thereafter data and information are collected in order to achieve the objectives of determining the law on practical completion and liquidated damages. Relevant information based on the secondary data from the published resources is collected and reported court cases are studied.

The courts' decisions, relevant legislation and provisions in standard form will then be analyzed in order to determine whether the stated objectives have been achieved. It is important in analysing the cases decided in order to determine the law and legal developments on issues of practical completion and liquidated damages.

Conclusion and recommendations is the final stage of the research whereby the findings would be able to conclude the result of the research. A conclusion will be drawn in-line with the objectives of the research. At the same time, some appropriate recommendations related to the problems may be made.

7. Overview of the Chapters

Chapter 1 sets the background of the study, identified the research issues, determined the objectives, scope and limitation of the study and the research methodology used during the process of research.

Chapter 2 explains briefly the nature and the governing law for construction contracts. Commonly used standard forms of construction contract are also briefly discussed here.

Chapter 3 discusses what amounts to practical completion and types of completion and effect of practical completion. Different judicial approaches as to the legal meaning of practical completion as also discussed and analyzed. Some standard forms used in Malaysia do provide some forms of definition for practical completion.

Chapter 4 explains the nature and rationale of liquidated damages and its distinction from penalty. It also discusses the conditions for liquidated damages clause to be enforceable and the situations where such clause ceased to be applicable.

Chapter 5 discusses the governing law on liquidated damages in Malaysia. This includes the scope of section 75 Contracts Act 1950 and the decided court cases under the said section. Ways to circumvent section 75 and the case of *Selva Kumar* are also proposed.

Chapter 6 concludes the findings of the research.

CHAPTER 2

NATURE OF CONSTRUCTION CONTRACT

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2.1 Definition of Construction Contract

The term "construction law" is now well accepted to cover the whole field of law which directly affects the construction industry and the legal instruments, such as contract document, bank guarantee and insurance through which it operates. Generally, construction projects are governed by contract law, tort and statutes.

What is a construction contract? There has been a great difficulty in formulating and acceptable definition of what a "construction contract" is. Duncan Wallace had attempted to define a construction contract as "a contract for the supply of materials or the carrying out of work, or any combination of those two, upon the land of another and which will become fixed to and a part of that land."[1]

In the UK, a statutory definition is now given to a construction contract, albeit a rather restricted definition for the purpose of payment and adjudication of construction dispute.[2]

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[1] Wallace, Duncan, *"Construction Contracts: Principles and Policies in Tort and Contract"*, 1st ed., (London: Sweet & Maxwell, 1988), at 457.

[2] "Construction contract" is defined in section 104 and 105 of the Housing Grants, Construction and Regeneration Act, 1996 as meaning an agreement for carrying out construction operation, including sub-contracted work and architectural design or surveying work or advise on building, engineering, decoration or landscape. The term 'construction operations" is widely defined in s105 of the Act to include building work, infrastructure work such as roadwork, power-lines, telecommunication work, water and sewerage work etc. It also includes related mechanical and electrical installation such as air-conditioning, fire fighting system, lighting, power supply etc. However, this definition excludes a long list of construction operations such as oil and gas project, nuclear plant, power generation plant, water treatment and sewage treatment plants.

2.2 Nature of A Construction Contract

Lord Diplock in *Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd*[3] described a construction contract as "an entire contract for the sale of goods and work and labour for a lump sum price".

Therefore, the relationship between a contractor and his Employer, reduced to its simplest term, the contractor may be considered to be in a position akin to that of a seller in a sale of goods transaction whereby in consideration for a sum of money, the seller (contractor) agrees to supply specified goods (a building) to the buyer (Employer). However, due to the size of financial commitments involved in construction contracts and the relatively long time for the "end product" to be produced, certain modifications are made to this simple transactional relationship.

One of the important modifications made is the introduction of progress payment provision into the contract whereby the contractor will be paid progressively at regular intervals (normally once a month) in accordance with the value of the work done.

The other major modification is that the contract empowers the architect or the engineer to vary the work. Such variation has the effect of changing, adding to or subtracting from the original work specified during the formation of contract. The legal effect of these powers is that the contractor must comply with these variation orders and if, as a consequence, he incurs additional cost and expense, he may seek financial compensation in accordance with the provisions in the contract.

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[3] [1974] AC 689

2.3 Standard Form of Construction Contract

Prior to the advent of standard forms, construction contract was typically drafted on the basis of loosely framed technical specifications. For example, in *Sharpe v San Paulo Railway*,[4] the Contractor undertook "to perform all the works necessary for the perfect execution and completion" of a railway. The engineer prepared new plans which required an additional two (2) million cubic yards of excavation. The court held that on these terms, the contractor was not entitled to claim for the extra excavation work.

Therefore, in order to overcome the above injustice caused by the imprecise terms, standard form of construction contract was introduced and an early standard form was cited in the case of *Clemence v Clarke*[5]. Over the years, this form gradually evolved into the modern day Joint Contracts Tribunal ("JCT") Standard form. In time, as the projects become more complex and demanding, the standard forms became more elaborate. As a result, the provisions of there forms evolved into a distinctive code of private law employing a distinctive terminology and a unique set of processes. These forms have also been the subject of considerable judicial interpretation over the years. Now the provisions of these forms became so entrenched that they were cited very much like statutes. In fact, English judge described it as a "legislative code".[6]

The main advantages of using a standard form are twofold. Firstly, it provides distinctive advantage that the terms of the contract are well understood by all parties. The contractors will be able to submit competitive bids based on common conditions of contract. So when the parties contract based on a widely used standard form, they will

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[4] [1873] LR 8 Ch App 597
[5] [1879] 28 LJ Ch 230
[6] *Amalgamated Building Contractors Ltd v Waltham Holy Cross UDC* [1952] 2 All ER 452 at 453 (CA)

benefit from a higher level of certainty of the operation of these standard terms and conditions.

Secondly, it will be time consuming if contracting parties are negotiation contract based on their own terms and conditions. Standard form, by virtue of their extensive usage, deal with the major issues such as payment, completion obligation etc, which have been carefully drafted to ensure fairness.

Today numerous types of standard forms are being used in construction industry and the most common ones used in the UK are JCT, New Engineers Contract ("NEC") and FIDIC.

2.4 Governing Law for Construction Contract

In UK, the governing law for construction contracts is laid down in the Housing Grants, Construction and Regeneration Act 1996. Sections 108 to 113 of the Act apply to all construction contracts as defined in section 104.[7] The Act does not cover all aspects of construction activities but focus on two main themes; to ensure prompt cash flow and to allow swift resolution of disputes by way of adjudication. The prime intention of enacting the Act is to provide a quick route to resolution of construction disputes.

In Australia, there is no specific statutory Act governing the construction contracts. The relevant laws are the law of contract, law of tort and some related statutory/regulatory legislations such as the Trade Practices Act 1974. The courts will generally apply common law principles in adjudication of construction disputes.

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[7] Section 104(1) of the Act defines a 'construction contract" as an agreement to carry out construction operations; or arranging for the carrying out construction operations by others under a subcontract or otherwise; or providing one's own labour or the labour of others for the carrying out of construction operations.

Similarly, Malaysia has no specific Construction Act governing the construction contracts and the construction law encompasses Contract law, tort and statutory/regulatory legislations. The law of Contract forms the core of the construction law and the governing legislation is the Contracts Act 1950. English common law is also widely applied in construction contracts by virtue of Civil Law Act 1956. The law of tort that is applied frequently in construction contract includes negligence, nuisance and vicarious liability. The statutes and regulations that are relevant to construction projects include the Town and Country Planning Act 1976, Street, Drainage and Building Act 1974 and Uniform Building By-Laws 1984.

CHAPTER 3

PRACTICAL COMPLETION

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PRACTICAL COMPLETION

3.1 Practical Completion- A Definition

The term 'practical completion' has been used extensively in most standard form of construction contracts for a long time and it is remarkable, in view of the frequent occasions upon which it is the subject of dispute, that it still has no firm legally defined meaning. The issue of whether a construction project has achieved practical completion is important as many of the standard forms of contract rely upon the issues of a Certificate of Practical Completion to trigger such matters as the exclusion of liability for liquidated damages, the release of the first moiety of retention and the start of the defects liability period.

Giving the importance of this matter, it is somewhat surprising that most of the standard forms used throughout the construction industry do not define completion. Instead, they generally leave the matter to the discretion of the architect, engineer and supervising officer.[8]

JCT 1998 has an unhelpful definition of practical completion under clause 17.1 which provides:

[8] For example, clause 15.1 of PAM 1998 provides that "when the Architect is of the opinion that the Works are practically completed....,the Architect shall forthwith issue a Certificate of Practical Completion."

"When in the opinion of the Architect, Practical Completion of the Works is achieved, ... he shall forthwith issue a Certificate to that effect and Practical Completion of the works shall be deemed for the purposes of the Contract to have taken place on the day named in such Certificate."

Commentators had also endeavored to define what amounts to practical completion. I. N. Duncan Wallace, wrote in 1969 in his Building and Civil Engineering Standard Forms[9], said:

"Practical completion is nowhere defined in the contract. Presumably it means such completion as will reasonably justify the architect in releasing the contractor from the site and in requiring the employer to enter into full beneficial occupation."

The editors of the Keating on Building Contracts submit that the following represents the correct meaning of "practical completion":[9A]

"Practical Completion is perhaps easier to recognize than to define. No clear answer emerges from the authorities as to the meaning of the term. ... It is submitted that the following is the correct analysis:

(a) the Works can be practically complete notwithstanding that there are latent defects;
(b) a Certificate of Practical Completion may not be issued if there are patent defects;
(c) Practical Completion means the completion of all the construction work that has to be done;

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[9] Wallace, IN Duncan, "*Building and Civil Engineering Standard Forms*" 1st ed., (London : Sweet & Maxwell, 1969)
[9A] Keating, Donald, "*Keating on Building Contracts*"7th ed., (London : Sweet & Maxwell, 2001) at 18-172

(d) However, the Architect is given discretion ... to certify practical completion where there are very minor items of work left incomplete on "de minimis" principles.

As such, whether or not the works are 'practically completed' is a matter for the opinion of the architect. However that opinion is subject to review by arbitrators on arbitration and frequently arbitrators found it to exist (or not) as a matter of fact and that the disputing parties alike have accepted that finding. But in reality, the meaning of words such as these, incorporated in a contract, is actually a question of law and the arbitrator has to adopt the acceptable legal definition of the term. Therefore, an architect or an arbitrator reviewing such an opinion must consider and take account of not only the facts and the individual circumstances but also the specific terms of the contract and the common law as expressed in decisions of the courts.

3.2 Judicial Approaches

As the courts have adopted different approaches in defining the expression "practical completion" and this has undoubtedly created much confusion and uncertainty to such an important legal term. Some of the approaches are not able to be reconciled with others whilst some are overly rigid and stringent. Various approaches adopted by the courts are discussed as follows:

(a) "Apparent Perfect" Approach

By far this is the most stringent approach and it adopts a high standard of performance in that the completion has to be "apparently perfect" and not substantially or practically completion.

This approach was adopted by the Australian Victorian State Supreme Court in *Morgan v S&S Construction Ltd.*[10] In this case, the trial judge held that "completion" in the context to mean, apart from merely trivial defects, "the reaching of a stage of construction at which the house is ready for occupation in all ways relevant to the contract and is free from known omissions or defects". On appeal, the Supreme Court of Victoria, affirming Lush J, that the proper view was that until all the works to be done had been carried out in accordance with the contract, except for departures from the contract which were either latent or undiscovered or merely trivial, it would not be "completed".

This approach has been criticized by commentators such as Keating as "practical nonsense".[11] In practice, there are frequently, if not almost invariably, many minor defects and incomplete works which do not prevent the employer taking occupation and can be carried out during the defect liability period.

(b) "No Patent Defect" Approach

In this approach, practical completion is taken to mean that there must be no defects apparent in the works at the date which the architect issues a Certificate of Practical Completion. However, the work shall be considered as practically completed notwithstanding that latent defects in the work which were subsequently discovered.

This rather strict, fault free approach was laid down by the House of Lord in *Westminster Corps v Jarvis and Sons.*[12] In this case, the House of Lord had to decide whether the main contractor was entitled to an extention of time under JCT 63 where delays occurred

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[10] [1967] VR 149
[11] Keating, Donald, *"Alwyn Waters Memorial Lecture : The Making of a Standard Form"*. [1995] Const. L.J. 11(3), 170 – 183
[12] [1970] 1 WLR 637

due to remedial works undertaken by the nominated piling sub-contractor after the piling work was completed and found to be defective. Practical Completion of the subcontract works is a relevant issue here as the court held that no extention of time was due in respects of delays caused by remedial works to the piling after the piling work had been completed.[13]

In this case, Viscount Dilhorne attempted to define practical completion where His Lordship said:

> "This contract does not define what is meant by 'practically completed'. One would normally say that a task was practically completed when it was almost but not entirely finished; but 'practical completion' suggests that that is not the intended meaning and that what is meant is the *completion of all the construction work that has to be done* ..."

His Lordship then went on to define what is meant by practical completion:

> "....what is meant [by 'practical completion'] is the *completion of all the construction work that has to be done* ..."

Similar approach was followed by the House of Lord later in *P&M Kaye v Hosier & Dickinson.*[14] Lord Diplock, in his obiter dicta expressed following view:

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[13] *Id.* Lord Hodson said in his judgment: The discovery of the latent defects in the piles showed that the subcontractor was in breach, not that it was in delay. It *did not return in order to complete its contract but to remedy the breach.* Time had already run out ... I think the judge was justified in his conclusion that, *notwithstanding the latent defects in the work which were discovered, there was apparent completion* on January 20th 1966 when the site was handed over to the contractor. [emphasis added]

[14] [1975] 1 W.L.R. 146 (HL)

"[It] starts when the contractor is given possession of the site ... It continues until he has completed the works ... so far as the *absence of any patent defects in materials or workmanship* are concerned. It ends with the issue by the architect of a certificate of practical completion ..." [emphasis added]

Therefore, there is no practical completion if a minute outstanding work is not done or the work is not hundred percent (100%) completed. This rather strict approach may cause injustice to the contractors as construction contracts are often massive and extremely complex. With the best will in the world, "minor breaches" or "omissions of small parts", to use the language of some court judgments, can probably be found on most contracts on a really careful inspection by an owner seeking an excuse to avoid payment or to impose liquidated damages for late completion. There does not seem to be any substantive reason why such 'omission of small parts' or 'minor breaches' should prevent the issue of a Certificate of Practical Completion if the works are in fact capable of being used for their intended purpose. The contractor's overriding obligation to carry out the whole of the works, and to remedy defects, still exists. In addition the value of any known defective or outstanding work will not be certified for payment and hence the Employer will not be exposed to unnecessary risk.

(c) "Intended Purpose" Approach

A more sensible and practical approach was proposed by the Court of Appeal in *Jarvis & Sons Ltd v Westminster Corp.*[15] where it was held that "practical completion" occurs when

[15] [1969] 1 W.L.R. 1448 (CA) Salmon L.J. (as he then as) said (likewise obiter) of the practical completion: The obligation on the contractors under clause 21 to complete the works by the date fixed for completion must, in my view, be an obligation to complete the works in the sense in which the words 'practically completed' are used in clause 15 and clause 16 of the contract. I take these words to mean *completion for practical purposes, i.e. for the purpose of allowing the council to take possession of the works and use them as intended.* If completion in clause 21 meant down to the last detail, however trivial and unimportant, the clause 22 (the liquidated damages clause) would be a penalty clause and unenforceable. [emphasis added]

the works are at such a stage that they are capable of being used by the Employer for the intended purpose for which they are apparently required. This definition appears to conform to the practicalities of building construction and common sense. It means that, for an architect exercising his opinion or for a tribunal reviewing that opinion, what has to be considered is a particular criterion rather than an abstract and undefined concept. The actual use of the works by the employer for the intended purpose will be prima facie evidence that the criterion has been met.

(d) "De Minimis" Approach

Another sensible approach was taken by the court in *H W Neville (Sunblest) Ltd v William Press and Sons Ltd.*[16]

In this case, the standard forms used is RIBA 63 and the contractor was employed to carry out site works consisting of site clearance, piling, foundation and drainage work prior to the erection of a bakery by another contractor. After practical completion had been certified and the contractor for the building had started work, defects were found in the drains and hard-standing. The contractor carried out remedial work, and in due course the architect issued a final certificate.

The Judge in this case adopted the "no patent defect" approach in the *Jarvis* case and modified that by reinforcing with the *de minimis* principle. Therefore, the architect may issue the Certificate of Practical Completion if, in his opinion, the work is practically

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[16] [1981] 20 B.L.R. 83 Judge Newey Q.C. said orbiterly: I think that the word 'practically' in Clause 15(1) gave the architect a discretion to certify that William Press had fulfilled its obligation under Clause 21(1), *where very minor de minimis work had not been carried out*, but that if there were any patent defects in what William Press had done the architect could not have given a certificate of practical completion. [emphasis added]

completed except with very minor items of work left incomplete under the '*de minimis*' principle and there is no patent defects.

Judge Newey reiterated similar comments in *Emson Eastern (in Receivership) v EME Development.*[17] His Lordship opined that it is virtually impossible to achieve a perfect completion in a construction contract. It must be rare where a new building is constructed in which every screw and every brush of paint is absolutely correct.

In this case, the contractor was engaged by a property developer to build business units and the standard form adopted was JCT 80. Practical Completion had been certified but the contractor subsequently went into receivership, whereupon the contract was automatically determined under the Conditions of Contract. The employer then had to employ other contractors to attend to remedial works.

This approach is more sensible than the strict approach by Viscount Dilhorne in *Jarvis*, but one issue remains unresolved. When can we decide that there is 'no patent defects'? It is submitted that if we adopt the de minimis approach, practical completion is achieved when there are only minor patent defects under the de minimis principle are discovered.

(e) "Possession" Approach

The court in *Impresa Castelli SpA v Cola Holdings Ltd*[18] tried to equate "exclusive possession" of the works to "practical completion".

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[17] [1991] 55 B.L.R. 114
[18] [2002] C.I.L.L. 1904

Judge Thornton, Q.C said:

> "It is clear that the nature of the possession and partial possession that are provided for is one of exclusive possession by the contractor or, once partial possession is taken, by the employer. The contractor, following its giving up possession or partial possession, has no further right to enter the part of the works taken possession of save for the express purpose of making good work as part of its obligation to make good defects in the work."

However in this case, the court held that the Employer did not have exclusive possession as the air conditioning system was still not completed and therefore the work was not "practically completed."

The same Judge also adopted similar approach in another case, *Skanska Construction (Regions) Ltd v Anglo-Amsterdam Corp*[19] which was decided only a month after that in *Impresa*. The court held that by taking partial possession of the whole of the works by the Employer will amount to practical completion.

This approach was criticized by some commentators as there does not appear to be anything in any of the standard forms or anywhere else to equate exclusive possession to practical completion. There may be cases that the work is still not completed but the Employer for some reasons need to take possession of the work for some purposes, such as to do fitting out work.

From the above observations, it is submitted that occupation by the employer does not in itself, constitute practical completion.

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[19] Reported in Construction and Engineering Law, [2003], 8.1, p 44.

From the above five different approaches adopted by various courts, it is submitted that the most sensible one is the "Intended Purpose" approach. This approach is practical and it provides clear-cut guidelines on what amounts to practical completion rather than relying on abstract concept such as minor defect, de minimis etc.

3.3 Substantial Completion and Practical Completion

Most standard forms use the expression of practical completion in their conditions of contract, such as JCT, Malaysia PAM, IEM and JKR 203A. However, FIDIC, ICE and most American standard forms use a different terminology of "substantial completion".

It is submitted that there is no difference between these two terms and Hudson has said succinctly:[20]

> "In English standard forms of contract ... this is often expressly described as 'practical' or 'substantial completion', but there is no reason to suppose that these expressions mean anything very different from the word 'completion' simpliciter when used or implied in the context of completion on time."

3.4 Effects of Practical Completion

It is of great importance to have a definite legal definition of 'practical completion" as the issuance of certificate of practical completion has many significant effects on the rights and liabilities of the parties.

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[20] Wallace, Duncan, "*Hudson's Building and Engineering Contracts*"11th ed.,(London : Sweet & Maxwell, 1995), at 9.043.

The effects of practical completion are the same under all the standard forms as it signifies:

(a) an end to liability for liquidated damages;

(b) an end of the construction period and commencement of the period of making good of all defects and defects liability;

(c) that half of the retention money becomes due for release to the contractor;

(d) an end of the certification of regular interim payments;

(e) an end of the contractors responsibility to insure the works against fire, theft, damage to third party property and injury to workmen;

(f) an end of the contractor administrator's power to require variations;

(g) an end of restriction on the reference of disputes to arbitration

3.5 Position in Malaysia

Some of the standard forms of construction contracts used in Malaysia such as PAM 1969, IEM and JKR 203 do not contain any definition to the meaning of practical completion. These forms only provide that when the works has reached completion according to the provisions of the contract and to the satisfaction of the contract administrator, certificate of completion shall be issued. It is apparent that whether or not the works is practically completed is a matter of the opinion of the contract administrator.

However PAM 1998 does provide a definition for practical completion and it is defined as "when the Architect is of the opinion that the works are practically completed, meaning that the Contractor has performed and *completed all the necessary Works specified in the*

Contract and the patent defects existing in such Works as "de minimis", ... "[21]. This clause seems to have adopted mixed views of "No Patent Defect" approach and "De Minimis" approach.

In CIDB Standard Form of Contract for Building Works (2000) a definition for practical completion is provided and it is defined as:

> "Completion of the Works including Test on Completion under the Contract ... Provided however the existence *of minor outstanding works and defects, which do not affect the functional use of the Works shall not affect Practical Completion* :[22]

In the updated PAM 2006, practical completion is defined as follows:

> "The works are practically completed when in the opinion of the Architect, the Employer can have *full use of the Works for their intended purposes, notwithstanding that there may be works and defects of a minor nature still to be executed* ..."[23]

Therefore, both the CIDB 2000 and PAM 2006 have adopted the mixed views of "De Minimis" approach and "Intended Purpose" approach.

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[21] Clause 15.1 of PAM Agreement and Conditions of Building Contract (Private Edition without Quantities), 1998.
[22] Clause 1.1 of CIDB Standard Form of Contract For Building Works, 2000.
[23] Clause 15.1(a) of PAM Contract 2006 (without Quantities).

In *PS Geotechnics Sdn Bhd v Merces Builders Sdn Bhd*,[24] Ian H.C. Chin J (as he then was), after citing *Jarvis & Sons v Westminster Corp*[25] and *H W Nevill v William Press*, [26] held as follows:

> "It seems to me both authorities [*Jarvis and H W Nevill*] were of the view that the certificate of practical completion cannot be issued if there are patent defects."

In *Chase Perdana Bhd v Pekeliling Triangle Sdn Bhd*,[27] the contract was agreed based on PAM 1969 Form of Contract in which no definition was given to the meaning of practical completion.

Here, Abdul Malik Ishak J referred to a textbook by Sundra Rajoo[28] and approved the author's views that "so long as there are patent defects the architect may not issue a practical completion certificate" and noted the preferred legal meaning of practical completion as listed in clause 15.1 of the PAM 1998 Form. In this case, the court relied on *Dakin v Lee*[29] and *Hoenig v Isaacs*[30] and held that the contract has been substantially performed and the plaintiff is entitled to sue for the price. The judge said:

> "It is a correct statement of the law to say and I so say that 'so long as there is a substantial performance the contractor is entitled to the stipulated price, subject only to a cross-action or counterclaim for the omission or defects in execution.' ... This must be the position of the law."

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[24] [2000] 1 LNS 349.
[25] *Supra* at 15.
[26] *Supra* at 16.
[27] [2001] 1 LNS 18
[28] Rajoo, Sundra, "*The Malaysian Standard Form of Building Contract (The PAM 1998 Form)*", 2nd ed., (Malaysia Law Journal, 1999) at p 142 – 144.
[29] [1916] 1 KB 566
[30] [1952] 2 All ER 176 (CA)

There is no case law on PAM 1998 and PAM 2006 whereby practical completion was clearly defined in these Standard Forms. It is submitted that the court should apply the "De Minimis" approach and "Intended Purpose" approach as the wordings clearly lay down the preferred legal meaning of the term.

In the situation where no definition is given to the phrase of practical completion it is submitted that the court is likely to continue to apply the "No Patent Defect" approach as decided in the cases of *PS Geothchnics Sdn Bhd* and *Chase Perdana Bhd*.

CHAPTER 4

LIQUIDATED DAMAGES

CHAPTER 4

GENERAL LAW ON LIQUIDATED DAMAGES

4.1 Introduction

Apart from contracts where time is held to be of the essence, the remedy for breach by the contractor of his obligation to complete the works on time lies generally in damages. In fact, damages is one of the most important remedies for breach of contract in the construction, but it requires two important legal hurdles to be overcome before an employer can recover them.

First, the injured party must prove he has incurred actual loss as a result of the breach, i.e.he must prove that he suffered losses but for the breach. Secondly the loss must not fall foul of the legal rules of remoteness as laid down in *Hadley v Baxendale*.[31]

Thus rules prevent recovery of losses which arise from special circumstances, unless the circumstances are known and there is an implied acceptance that the contract was directed to these circumstances. In practice, this means that the injured party is faced with expensive legal action if he is to obtain compensation for the losses suffered due to the breach. Therefore, in order to avoid the expense and effort to prove damages from first principles, most construction contracts have opted for a pre-agreed rate of damages for each day or week by which the completion has been delayed. The concept of liquidated damages was gradually developed in order to quantify, or "liquidate", at the

[31] [1854] 9 Exch. 341. See also *Victoria Laundry (Windsor) Ltd v Newman Industries Ltd* [1949] 2 KB 528

outset of a contract the amount a party is required to pay in the event it breaches a contractual obligation. Just as the parties at the time of contracting can agree their obligations under the contract, so they can agree the amount of compensation to be paid if the particular obligation is not performed. There is no need to look for an implied agreement in the contract to compensate for the losses due to these special circumstances.

The rate stipulated, as liquidated damages to be paid when certain obligation is breached, is an estimate that the injured party is likely to suffer in the event that the obligation is breached. The liquidated damages clause is an express agreement, so compensation is payable whether or not the special circumstances which make the loss likely are known. In other words the parties are not bound by the rules as to causation and remoteness for the particular breach specified.

Diplock LJ in *Robophone Facilities Ltd v Blank*[32] expressed his agreement to the liquidated damages clause and said:

> "I see no reason in public policy why the parties should not enter into so sensible an arrangement under which each know where they stand in the event of a breach by the defendant and can avoid the heavy costs of proving the actual damages if litigation ensues."

It is now a standard practice in all the standard forms of construction contracts to incorporate a liquidated damages clause. There are also abundance of case law and judicial interpretation in relation to the concept of "liquidated damages".

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[32] [1966] 1 WLR 1428

The difficulty in proving damages in construction contract was explained by Croom-Johnson LJ in *Temloc Ltd v Errill Properties Ltd*[33] where his Lordship said:

> "There is every reason why parties to building contracts should agree to liquidated damages for non-completion. Proof of such a loss is often difficult to achieve and agreement in advance is a saver of dispute."

The English law has traditionally disfavoured the concept of liquidated damages and draws a distinction between "liquidated damages" and a "penalty". Liquidated damages are genuine pre-estimates of the loss which will be enforceable by the court. On the other hand, when the stipulated sum is extravagant and unconscionable in comparison with the greatest loss which could be contemplated by the parties at the date when the contract was executed, it is termed as "penalty" and the court will not enforce this clause, notwithstanding that this was mutually agreed by both parties earlier.

In short, the primary question is, whether the parties honestly endeavoured to fix a sum or equivalent in value to the loss or damage caused by the breach? The reasonableness or unreasonableness of the stipulation is a critical factor to consider.

4.2 Rationale of Liquidated Damages Clause

The liquidated damages clause is now widely accepted in the construction industry and it is a standard practice in construction contracts to include such clause. Its popularity is well supported by sound commercial reasons such as it saves time and cost on proving damages and it provides certainty of risk to both contracting parties:

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[33] [1988] 4 Const. LJ 63 (CA)

(a) Save Cost on Proving Damages

As explained earlier in 4.1, the injured party has to satisfy the tests on causation and remoteness in order to succeed in claims for damages against the other party. By this mechanism of liquidated damages clause, disputes are either avoided altogether or if there is a dispute the cost involved in proving damages is avoided. A liquidated damages provision is therefore commercially very attractive to both parties since it avoids the need to ascertain the quantum of damages.[34]

In construction industry, it is not easy to prove the damages from breach of the contract, such as late completion. For example in *Clydebank Engineering and Ship Building Co Ltd v Don Jose Ramos*[35] it is almost impossible to prove the damages for late delivery of war ships. The House of Lords opined that "the nature of the damage is such that proof of it is extremely difficult, complex and expensive."

(b) Certainty of Risk

The provision of liquidated damages clause also allows the contractor to know, when he tenders for the construction of the works, precisely the level of his liability for the risk inherent in the particular obligation and hence may allow the contractor to reduce the prices of his bid which is to the advantages of both parties. If the contractor feels that he is not able to take the risk of such level of damages stated for the breach, for example late

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[34] In *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, Diplock LJ, when summing up the benefits of such a clause to both parties, said: "Such a stipulation [of liquidated damages] reflects good business sense and is advantageous to both parties. It enables them to envisage the financial consequences of a breach; and if litigation proves inevitable it avoids the difficulty and the legal costs, often heavy, of proving what loss has in fact been suffered by the innocent party."

[35] [1905] 3 AC 6

completion, he can withdraw from the bid. This clause also enables the employer to know the extent to which he is protected in the event the project is delayed.[36]

However, the effect of the mechanism of liquidated damages clause in reducing a tender price benefits the employer only if the extent of the risk which materializes is not greater than allowed for in the liquidated damages clause. If not, then the liquidated damages clause will have had the effect of passing part of the risk from the contractor to the employer.

Therefore, the liquidated damages provision brings certainty to the tendering process, enabling the tenderer to price a known risk and the employer to be better able to compare and evaluate tenders which have priced the contingency of delay in a uniform way. Certainty also means the contractor who is in culpable delay can evaluate the costs of forfeiting liquidated damages to the employer as against the cost to himself of putting greater resources into the project to accelerate progress and mitigate the exposure to those liquidated damages.

4.3 Features of Liquidated Damages

4.3.1 Agreement

The courts have adopted the view that liquidated damages clause must be upheld by the courts as they are made voluntarily by mutual agreement. This view was expressed by the courts in numerous cases.

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[36] In *Philips Hong Kong Ltd v The Attorney General of Hong Kong* [1993] 61 BLR 41, Lord Woolf said: "Since it is to their [the parties'] advantages that they should be able to know with a reasonable degree of certain the extent of their liability and the risk which they run as a result of entering into the contract. This is particularly true in the case of building and engineering contracts. In the case of those contracts provision for liquidated damages should enable the Employer to know the extent to which he is protected in the event of the contractor failing to perform his obligations."

Lord Halsbury in *Clydebank Engineering and Ship Building Co. Ltd v Don Jose Ramos* [37] said:

> "... the parties may agree beforehand to say 'such and such a sum shall be damage if I break my agreement."

Again in *Temloc Ltd v Errill Properties Ltd*[38], Croom-Johnson LJ expressed similar view:

> "It was open to the parties to agree what they liked provided it did not amount in a penalty."

It has also been held in *Bath & NE Somerset DC v Mowlem*[39] that the agreed liquidated damages may not necessary be the actual loss that the parties envisaged to suffer.

4.3.2 Genuine Pre-Estimate

Liquidated damages was held to be genuine pre-estimates of the loss which is likely to flow from any breach of contract and will, if the breach is proved, be upheld and enforced by the courts as the quantum of damages to be paid by the guilty party.

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[37] *Supra* at 35. See also *Webster v Bosanquet* [1912] AC 394.

[38] *Supra* at 33.

[39] [2004] EWCA Civ 115, Mance LJ opined that "it cannot be assumed that the parties either regarded or agreed it as the measure of the full loss likely to be suffered ... The parties may well, for commercial reasons, have concentrated on and covered only certain easily quantified items of cost. ... Or they may deliberately have agreed to limit the financial loss recoverable."

Lord Dunedin in the landmark case of *Dunlop Pneumatic Tyre Co v New Garage & Motor Co*[40] said:

> "... the essence of liquidated damages is a genuine covenanted pre-estimate of damages."

In estimating the damages, it is clear that something more than 'honesty' and 'good faith' and 'genuineness' is required. The pre-estimate need not be genuine, in the sense that it does not need to reflect possible actual loss, but it must be a reasonable sum. The pre-estimate must be a reasonable forecast and it is immaterial what will be the actual damages when the breach occurs. If, however, the pre-estimate is found to be unreasonable, then the liquidated damages clause, notwithstanding that it has been genuinely estimated, will be treated as penalty and will become void. In this instance, the Court will only award reasonable compensation.

In *Alfred McAlphine Capital Projects Ltd v Tilebox Ltd*[41], the court held that although many authorities use the phrase 'genuine pre-estimate', the test does not turn upon the genuineness or honesty of the parties who made the pre-estimate. The test is primarily an objective one, even though the courts have some regard to the thought processes of the parties at the time of contracting. The court also reconciled two apparent strands to the authorities. One strand was the test that there should be no great disproportion between the actual damages and the liquidated damages rate. The other strand was that the liquidated damages should be reasonable. The important point was that the liquidated damages rate need not be right to be reasonable, but would be unreasonable if disproportionate to the likely level of loss.

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[40] [1915] AC 79
[41] [2005] EWHC 281 TCC

4.3.3 Damages Need Not Be Proved

When a liquidated damages sum is a genuine pre-estimate of loss, it is fundamental that loss does not have to be proved to obtain recovery. The injured party is entitled to recover the sum expressed as liquidated damages without being required to prove actual damage and the court will not inquire into the actual loss suffered.[42]

The parties to a contract are bound by the terms agreed and the court will enforce those terms except where they are held to be penalties or they are void for infringing other legal rules. The courts will not alter the contract the parties have made for themselves.

4.3.4 Losses Need Not Be Suffered

If the liquidated damages provision is valid, then the court will award the sum to the injured party notwithstanding that he suffers no loss at the time of breach.

In *BFI Group of Companies Ltd v DCB Integration Systems Ltd*[43], the arbitrator held that there had been a delay in completion but refused to award liquidated damages on the grounds that the Employer had suffered no resulting loss. On appeal, the judge held that the liquidated damages clause come into play when the contractor completed late without a contractual justification and the Employer was not required to demonstrate that he has suffered loss. The arbitrator was wrong in law in refusing to award payment of liquidated damages.

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[42] *Wallis v Smith* [1882] 21 Ch. D 243 at 267., per Cotton LJ.
[43] [1987] CILL 348

4.3.5 Onus of Proof

A liquidated damages clause stipulated in a contract is *prima facie* valid and enforceable unless proven to be a penalty.

In *Robophone Facilities Ltd v Blank*[44], Diplock LJ stated:

> "The onus of showing that a stipulation is a penalty clause lies upon the party who is sued upon it ..."

Accordingly a contractor challenging the application of a liquidated damages clause as being a penalty bears the burden to prove that his allegation is correct. It is not for the Employer to prove that the liquidated damages amount is a reasonable pre-estimate of loss. The liquidated damages clause agreed by the parties is prima facie a reasonable pre-estimate of the loss.

The above principle was later confirmed by the Court of Appeal in *Jeancharm Ltd v Barnet Football Club Ltd.*[45]

4.4 Liquidated Damages and Penalty Clauses - An Overview

In *Law v Local Board of Redditch*[46], the court described how the courts of equity developed the rule against penalty clauses. The rule was then taken over by the courts of law, which looked at phrases used, such as 'penalty' or 'liquidated damages'.

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[44] *Supra* at 32.
[45] [2003] EWCA Civ 58.

In *Clydebank Engineering and Shipbuilding Co. Ltd v Don Jose Ramos*[47], the House of Lord upheld a liquidated damages clause notwithstanding that the injured party may not suffer any loss at all due to late delivery of warships.

In *Commissioner of Public Works v Hills*[48], Lord Dunedin formulated the test on liquidated damages and penalty. The distinction lies on the question whether the stipulated sum is a 'genuine pre-estimate of the probable losses.' On the facts, the Court held that the stipulated sum is a penalty and not enforceable.

Lord Dunedin returned to this topic in the well-known decision in *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co*[49]. His Lordship reviewed earlier authorities and set out a series of propositions, which have often been cited and relied upon for the last ninety (90) years. We will discuss the propositions in detail in 4.5.

The Court of Appeal in *Robophone Facilities Ltd v Blank*[50] upheld a liquidated damages clause and Diplock LJ said His Lordship "see no ground in authority which would permit, much less compel him to hold that the clause is a 'penalty clause'.

In *Philips Hong Kong Ltd v the AG of Hong Kong*[51] the Privy Council decided that the liquidated damages clause in a construction contract was valid and enforceable. Lord Woolf cited with approval the passage from Lord Dunedin's speech in *Dunlop* case and said:

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[47] *Supra* at 35.
[48] [1906] AC 368 (PC).
[49] *Supra* at 40.
[50] *Supra* at 32.
[51] [1993] 61 BLR 41.

"... so long as the sum payable in the event of non-compliance with the contract is not extravagant, having regard to the range of loses that it could reasonably be anticipated it would have to cover at the time that the contract was made, it can still be a genuine pre-estimate of the loss that would be suffered and so a perfectly valid liquidated damage provision."

From the above cases, one will notice that the court will strike down a liquidated damages clause notwithstanding that it has been mutually agreed. However if the agreed liquidated damages is reasonable, the court will uphold the clause and will not rewrite the contract for the parties. The courts have drawn distinction between penalties and liquidated damages by reconciling two competing public policy consideration – freedom of contract on the one hand and the prevention of unconscionable and oppressive conduct on the other. The other reason for judicial interference is that the purpose of an award of damages is to compensate the injured party; it follows that it would be illegitimate to allow a clause in a contract that stipulated for a sum which is in excess of the actual loss suffered.[52]

The doctrine of freedom of contract is premised upon the enforcement of contractual intent of the contracting parties. Therefore any clause that is the product of private bargaining, as in the case of construction contracts, should be strictly enforced. Contract law should provide relief only when the contract is a product of a process that is not within the private bargaining paradigm.[53] The private bargaining paradigm is premised on the belief that a contract represents the mutual assent of the parties. In contrast to the non-

[52] *Export Credits Guarantee Department v Universal Oil Products* [1983] 2 Lloyd's Rep 152, at 155. Lord Roskill said: "Perhaps the main purpose of the law relating to penalty clauses is to prevent a plaintiff recovering a sum of money in respect of a breach of contract committed by a defendant which bears little or no relationship in relation to the loss actually suffered by the plaintiff as a result of the breach by the defendant.

[53] Lord Radcliffe in *Bridge v Campbell Discount Co Ltd* [1962] AC 600 stated the position of the court in this doctrine as: "The courts of equity never undertook to serve as a general adjustor of men's bargain."

enforcement of penalty clauses, the motivating force behind the enforcement of reasonable liquidated damages clause is the parties' intent to provide just compensation. If the intent of the clause is to provide just compensation to the innocent party, then it should be enforced. However, if the amount stipulated provides a windfall then it cannot be justified under the just compensation principle that underlines common law contract damages.

Thus, it is submitted that liquidated damages clauses should be presumed enforceable. If it can be shown that a clause was a part of the basis of bargain, then its full enforcement will be consistent with the intentions of the parties and will reduce the need for lengthy and costly litigation on issues of liability and the amount of damages to be awarded.[54]

4.5 Liquidated Damages and Penalties Distinguished

If the agreed sum, whatever it is called in the contract, is a penalty it will not be enforced by the courts.[55] It is sometimes a matter of some difficulty to determine whether agreed damages are, in the particular circumstances of the case, penalties or liquidated damages, but the principles applied by the courts are well established. The essence of penalty is a payment to terrorize the contract breakers; the essence of liquidated damages is a genuine covenanted pre-estimate of damages.

The distinction between a penalty and liquidated damages was first set out by Lopes J in *Law v Local Board of Redditch*[56],

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[54] In *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* [2005] EWHC 281, Jackson J remarked: "It is an anomalous feature of the law of contract that the court will strike down penalty clauses. This is not part of any wider doctrine which requires or permits the courts to rewrite contracts or to strike out clauses which are unduly harsh as between the contracting parties."

[55] *Watts, Watts & Co Ltd v Mitsui & Co. Ltd* [1917] AC 227 (HL)

[56] *Supra* at 46

"If the intention is to secure performance of the contract by the imposition of a fine or penalty, then the sum specified is a penalty; but if, on the other hand, the intention is to assess the damages for breach of the contract, it is liquidated damages,"

Lord Dunedin summarized the law on liquidated damages in *Dunlop Pneumatic Tyres Co Ltd v New Garage and Motor Co Ltd*[67] as follows:

"1. Though the parties to a contract who use the words 'penalty' or 'liquidated damages' may prima facie be supposed to mean what they say, yet the expression used is not conclusive. The court must find out whether the payment stipulated is in truth a penalty or liquidated damages.

2. The essence of a penalty is a payment of money stipulated as *in terrorem* of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage.

3. The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judge of as at the time of making the contract, not as at the time of the breach.

4. To assist this task of construction, various tests have been suggested, which if applicable to the case under consideration may prove helpful, or even conclusive. Such are:

(a) It will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.

(b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid. This, though one of the most ancient instances, is truly a corollary to the last test.

(c) There is a presumption (but no more) that it is a penalty when 'a single sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damages.

(d) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable the pre-estimate damage was the true bargain between the parties.

Peter Gibson LJ in *Jeancharm Ltd v Barnet Football Club Ltd*[58], summarized the key principles enunciated by Lord Dunedin in distinguishing a penalty provision as follows:

(a) The court looks at the substance of the matter rather than the form of words, to determine what was the real intention of the parties;

[58] *Supra* at 45

(b) The essence of a penalty is a required payment in terrorem of the party in default, as distinct from being a genuine pre-estimate of loss resulting from the default;

(c) The question whether a provision for payment on default is a penalty is a question of construction of the contract and that is assessed at the time of the contract and not at the time of the breach;

(d) If the required payment is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be established as the consequence of a default, it is a penalty

His Lordship held that the test remained one of ascertaining whether the provision was a genuine pre-estimate of loss or was a penalty for non-performance of the contractual obligation. The first type of provision was essentially compensating in nature. The second was there to deter the party in question from breaking the contract by providing for a punitive level of payment.

His Lordship considered that the court was concerned to construe the contract to see whether the intention of the parties at the time of the contract was to deter the paying party from falling into default. If it can be seen that the provision is a genuine pre-estimate of the loss that will result from the default, then there can be no penalty.

Problems of Distinction

(a) The legal distinction between liquidated damages and penalty clauses rests on the assumption that they have an unequivocally divisible nature. In other words, it presupposes that they are either one thing or the other. But this presumption and analysis are not without problem. Even where one 'purpose' of the clause

overshadows the other it is not always the case that the other 'purpose' will be completely eliminated. Where the intention of the parties is not clear, or where their function is twofold, that is to include both a coercive and compensatory element to the clause, then predicting the legitimacy of judicial control on the parties having a singular purpose will be artificial.[59]

(b) What exactly is meant by a "genuine pre-estimate" of damages? How do we know whether the parties agreed 'genuinely' on the pre-estimate? As the liquidated damages clause is mutually agreed by both parties, logically, the pre-estimate must have been genuine. This is more obvious in construction contracts where both contracting parties are negotiating on almost equal bargaining power.

(c) A different problem arises where either a change in circumstances occurred between the time of contract and breach or this has resulted in an increased quantum of damages. In this case, what may have been stipulated in terrorem results in a 'penalty' inferior to actual loss suffered.[60] This paradoxical situation offers two possible solutions; either the 'penalty' could be disregarded allowing the injured party to claim damages for actual loss[61], or it will act as a limit on the amount of damages recoverable by the injured party.[62] The courts are not of the same view on this problem and shall remain as an uncertainty in the near future.

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[59] The difficulty with the distinction is evidenced in the contradictory cases of *Dunlop* and *Ford Motor Co v Armstrong* [1915] 31 TLR 267

[60] See Barton, *'Penalties and Damages'* [1976] 92 LQR 26; Gordon [1974] 90 LQR 296; Hudson *'Penalties Limiting Damages'* [1974] 90 LQR 30

[61] *Wall v Rederiaktiebolaget Lugudde* [1915] 3 KB 66

[62] *Elsley v Collins Insurance Agencies* [1978] 83 DLR (3d) 1. Canadian Supreme Court

4.6 Conditions for Liquidated Damages Clause to be Enforceable

In situations where completion of works is delayed, the Employer may seek to claim liquidated damages in accordance with the terms of the contract. In order to enforce the liquidated damages clause in law, following conditions must be complied with:

- **Not A Penalty**

The liquidated damages clause must not be a penalty. If the agreed sum, whatever it is named in the contract, is a penalty it will not be enforced by the courts.[63] The onus of proving that the clause is a penalty clause lies upon the party who is sued upon it, and the "court should not be astute to descry a 'penalty clause'"[64]

The party who resists the enforcement of the liquidated damages clause may argue on the ground that it is not a genuine pre-estimate of the probable damage and that it is unconscionable.[65] To determine whether the stipulation is a liquidated damages or a penalty clause, the classical tests to be applied are the expositions by Lord Dunedin in the *Dunlop* case. The fact that a clause is described as a liquidated damages clause and not a penalty clause does not prevent it from being determined by the court as a penalty. The court in *Commissioner of Public Works v Hills*[66], said:

> "The question whether a sum stipulated is a penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances

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[63] *Wall v Rederiaktiebolaget* [1915] 3 KB 66; cf *Jobson v Johnson* [1989] 1 WLR 1026 (CA)
[64] *Robophone Facilities v Blank* [1966] 1 WLR 1428 at 1447 (CA)
[65] *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co* [1915] AC 79 (HL); approved by the Privy Council in *Philips Hong Kong Ltd v The AG of Hong Kong* [1993] 61 BLR 41

of each particular contract, judged of as at the time of the making of the contract, not as at the time of the breach".

Likewise, the fact that a clause is named as a penalty clause, however, does not prevent it from being enforceable as liquidated damages if the sum has in fact been properly ascertained and is reasonable.

- **Date for Damages to Run**

Another condition for the enforceability of liquidated damages clauses for delay is that there must be a specific and definite date from which the damages are to run.[67] If no such date is fixed by the parties in the contract, all rights to recover the sum stipulated as liquidated damages will be gone.[68] The court will not fix a date from conflicting oral evidence.[69]

This date may be the completion date originally fixed or any other date that has been substituted under the provisions of an extention of time clause in the contract. In the later case, the procedure for extending time must have been properly followed and such requirement will be construed strictly by the court.

- **Conditions Precedent To Be Observed**

Some contracts require certain conditions precedent to be complied with before the imposition of liquidated damages by the Employer. One example is the issuance of a certificate of non-completion under JCT Contract 1980 by the architect. Generally in all

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[67] *Peak Construction (Liverpool) Ltd v McKinney Foundations Ltd* [1971] 69 LGR 1 (CA)
[68] *Dodd v Churton* [1897] 1 QB 562 (CA)
[69] *Kemp v Rose* [1858] 1 Giff. 258 at 266

matters of contractual remedies the court will apply *contra proferentem* rules to ensure that the stipulated administrative procedures are adhered to. Therefore any failure to comply with the required administrative procedure may render the liquidated damages clause unenforceable.

Under clause 24.1 of the JCT 80, the Employer can only proceed to deduct liquidated damages when the architect has issued a certificate that the contractor has failed to complete the works by the agreed completion date. Such a requirement is construed strictly by the courts because it provides certainty necessary for the proper operation of the terms of a construction contract.

In *A Bell and Son (Paddington) Ltd v CBF Residential Care and Housing Association*[70], the court held that the Employer lost the right to deduct liquidated damages as the certificate of non-completion was not issued by the Architect as required under the contract. In this case, the Architect had granted an extention of time that cancelled the previous non-completion certificate under the JCT 80 form and he had not issued a replacement certificate.

The matter of a non-completion certificate was again referred to in *J F Finnegan Ltd v Community Housing Ltd*[71] and *Halliday Construction Ltd v Gowrie Housing Association Ltd*[72] where it was held that a written notice from the Employer that he might deduct liquidated damages under clause 24.2.1 of the JCT 80 amounts to a certificate of non-completion and it is a condition precedent to the right to deduct liquidated damages.

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[70] [1989] 46 BLR 102

[71] [1993] 65 BLR 103 (CA); approving the decision in *A Bell & Son v CBF* [1989] 46 BLR 102 and distinguishing *Jarvis Brent Ltd v Rowlinson Constructions Ltd* [1990] 6 Const LJ 292

4.7 Rate of Liquidated Damages to be Stated

The rate of liquidated damages to be imposed upon delay in completion of the works must be stated clearly in the contract in order to enforce the liquidated damages clause. If the rate of liquidated damages is stated to be 'nil', then it is construed that the Employer does not intend to impose any damages for the delay and it is also not opened to the injured party to claim for general damages.

In *Temloc Ltd v Erill Properties Ltd*[73], the parties provided in the Appendix of a JCT 80 standard form against clause 24.2 that liquidated damages for delay should be "£ nil". The Court of Appeal held that on a proper construction of the contract the parties had agreed that there should be no damages for delayed completion and also it was not open to the Employer to claim general damages in lieu thereof as it constitute an exhaustive agreement of the damages.

While this decision remains authority in England, there had been much debates among the commentators whether this decision is just. It has been argued that whether the court in deciding as it did gave sufficient consideration to the possibility that the parties could have simply intended that the liquidated damages clause should not apply but to leave it open. It is unlikely that the parties, when deciding on 'nil' damages, intended to exclude general damages also.

A similar situation arose in an Australian case of *Baese Pty Ltd v Bracken Building Pty Ltd*[74] where nil liquidated damages was entered into the contract. The Supreme Court of New South Wales declined to follow the decision in *Temloc* and held that the liquidated

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[73] *Supra* at 33
[74] [1989] 52 BLR 134

damages clause was not an exhaustive statement of entitlement to damages and the function of the clause was to provide a mechanism for invoking liquidated damages if the employer so wished but if he did not do so he was entitled to rely on his common law rights.

The decision was premised on giving the phrase 'if such notice is given' (in relation to the architect's duty to issue a certificate on non-completion) a different effect from the phrase 'then the architect shall' which was used in *Temloc*. "If" was taken to give the employer an option whereas "shall" was said to be imperative and this meant that the employer has the option to either to sue for liquidated damages or actual damages.

What if 'N/A' was filled in the Appendix to the contract in the column of liquidated damages? This happened to a contract in an Australian case of *CS Phillips Pty Ltd v Baulderstone Hornibrook Pty Ltd*[75]. In that case the parties wrote 'N/A' in the annexure for liquidated damages. The Supreme Court of New South Wales found that 'N/A' had the same effect as 'NIL' and that the contract, like *Temloc*, was expressed to mean that the liquidated damages clause was the only remedy for delay. Once that clause was agreed as "not applicable" there were no rights under the contract to recover any general damages for delay.

However, it is submitted that *Temloc* does not provide a firm ruling on contracts where a 'dash' is made in the Appendix or where the rate space is left blank and it is possible that in such cases the ruling in *Temloc* does not apply.

[75] [illegible] NSWSC, unreported, 26 October 1994, Giles J.

4.8 Situations Where a Liquidated Damages Clause Ceased to be Applicable

There are situations where a liquidated damages clause will cease to be applicable notwithstanding that the conditions for enforcement of a liquidated damages clause are complied with. These situations that render a liquidated damages clause inoperable may be due to the preventive action of the Employer or the rights to claim liquidated damages have been waived.

- **Extension of Time is Granted**

It is common in construction contract that the completion time fixed by the contract ceases to be applicable due to some act or default of the employer or his architect or engineer. Examples of such act of prevention by the employer are: ordering extras; not providing the site at the agreed time; failure to supply drawings and failure to supply materials which the employer has agreed to provide. An extension of time provision, therefore, is inserted into the contract in order to avoid such acts of prevention resulted in the loss of right by the employer to claim for liquidated damages. The provision will normally empower the architect or engineer to grant an extention of time on the happening of certain specified events and the contractor is bound to complete the works by the extended time. This has the effect of substituting the time fixed by the contract to a new date from which the liquidated damages are to run. In this instance, the contractor will not be liable for the liquidated damages during the extended period but will be liable if he fails to complete by the extended date.

However, there are other acts which may delay the completion of the works but are not caused by the employer such as exceptionally inclement weather, strikes and *force majeure*, shortage of materials and labour. These events, which though they may cause

unavoidable delay to the works, might not relieve the contractor from the liability to liquidated damages. If there is no express power provided in the contract to extend time for a delay which is not the fault of the employer, the contractor takes the risk of that delay and will be liable to liquidated damages.[76]

- **Time At Large**

In construction contracts, the date for completion will normally be stated in the contract. The term 'time at large' is not a legal term, but describes the situation where there is no identified date for completion, either by absence from the contract terms or arising from events and the operation of law. Time is said to be at large because the time for completion is not fixed before carrying but the work, but determined after the work has been completed. If time is at large, then it is argued that liquidated damages cannot be applied, because there is no date fixed from which the liquidated damages can be calculated. In addition the contractor's obligation is now merely to finish within a reasonable time.

In its simplest form time is said to be at large where there is no specific time for completion or where a previously fixed time for completion no longer applies. This can occur in two main ways; firstly, where agreement for work is entered into without a completion date being stated. Common examples of this type of situation are found in contracts formed by exchange of letters without a completion date being agreed. Where there is no subsequent agreement as to time for completion then time will be said to be at large.

The second situation occurs where a previously agreed time for completion has been rendered inoperable. This can occur in a number of ways and the most common of which is where there is an act of prevention by the employer for which there is no express provision within the contract for extending the completion date. These acts of prevention may vary from an omission of the part of the employer, for example to provide drawings or materials; or a fault; or even the ordering of variations which is fully contemplated by the contract.[77]

In *Peak Construction (Liverpool) Ltd v Mckinney Foundations Ltd*[78], the Court of Appeal held that as delays on the part of the City Council in approving remedial works to the piling were not provided for in the extention of time provisions, the right to liquidated damages was lost and time became at large. The Corporation was left with an entitlement to claim such common law damages as a result of the contractor failing to complete within a reasonable time as it was able to prove.

In *Rapid Building Group Ltd v Ealing Family Housing Association*[79], the contract involved is JCT 63 standard form. Ealing was unable to give possession of the site to the contractor on the due date due to presence of squatters (a man, his wife and his dog). There was no provision in JCT 63 for extention of time for late possession of site. The Court of Appeal followed *Peak Construction* and held that the time is at large and the liquidated damages provisions fell away.

The doctrine of time at large was applied in Malaysia by the Federal Court in *Sim Chio Huat v Wong Ted Fooi.*[80] In this case, the contract contained a liquidated damages

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[77] *Dodd v Churton* [1897] 1 QB 562 (CA)
[78] [1970] 1 BLR 114, [1971] 69 LGR 1
[79] [1984] 29 BLR 5

clause but did not incorporate any extention of time provision. The court held that the employer's delay in providing site possession and the ordering of extra work in the circumstances had set the time at large and consequently rendered the liquidated damages clause inoperable. This case was later referred to in *Syarikat Soo Brothers Construction v Gazfiu Sdn Bhd*[81] and *Thamesa Designs Sdn Bhd v Kuching Hotels Sdn Bhd*[82].

In *Thamesa Designs*, the employer granted possession of site late and was held to be prevented from imposing liquidated damages in respect of delays subsequently caused by the contractor. The form of contract used was PAM 1966 which is similar to JCT 63 on this point.

- **Contract Terminated by Employer**

When a contractor is not able to complete the works either because the contract was determined lawfully by the employer or because either party alleges repudiation and was terminated under common law, the question arises whether the provisions for liquidated damages still apply. There are two scenarios to be considered: one situation is where the contract is terminated before the contracted completion date while the other situation is where it is terminated after the contracted completion date.

For situation where the contract is terminated before the contracted completion date, it has been held that in the absence of express provision in the contract, the contractor is not liable for any liquidated damages accruing after the date of determination[83]. In *British*

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[81] [1989] 1 MLJ 64

[82] [1993] 3 MLJ 25 (SC)

[83] [1876] 4 Ch D 724; *Suisse Atlantique, etc v NV Rotterdamsche Kolen*

Glanzstoff Manufacturing Co Ltd v General Accident Assurance Corp[84], the contractor became bankrupt and suspended the works before the contracted completion date, the employer thereupon engaged another firm to complete them, but works were only completed six weeks after the original completion date. The employer claimed liquidated damages for delay but the House of Lord held that liquidated damages clause applied only where the contractor himself completed the contract and did not apply where the control of the contract had passed out of their hands.[85] The employer is only allowed to claim for unliquidated damages that they can prove. However if the contract has expressly provided for means to ascertain a date up to which the liquidated damages are to run, or declares that termination is "not to affect in any other respect the liabilities of the contractor", the employer may be entitled to liquidated damages up to the time of actual completion. In such a case, there is no determination of the contract but only a forfeiture of certain rights.

In the second situation where the contract is terminated after the completion date, in the absence of special provision, it has been held that liquidated damages will be recoverable by the employer,[86] but in respect of any later delay the employer will be required to prove his damages and claims unliquidated damages.[87] It should be noted that in such an event, the employer's losses will probably arise under two main heads namely damages for the delay and the additional cost to complete the works. It is the first only of these heads which will be affected by a liquidated damages clause conditional on delay in completion.

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[84] [1913] AC 143 (HL)

[85] In *Re Yeadon Waterworks Co and Wright* [1895] 72 LT 538, Kennedy J said: "having elected to dispossess the contractor and taken the performance of the contract out of his hands they must have been taken to abandon their right to these damages."

[86] *Simpson v Trim Town Commissioners* [1898] 32 ILT Rep 129, Ireland

[87] [illegible] 29 NBR 631, New Brunswick Court of Appeal

In *Felton v Wharrie*[88], the employer engaged another contractor to complete the works when the contractor failed to complete within the specified completion time. Lord Alverstone CJ held that the employer is entitled to liquidated damages up to the time of taking possession of the works but not after that.

- **Waiver**

An employer can always expressly waive the right to liquidated damages by undertaking not to enforce the clause at all or to extend the time from which liquidated damages are to run. Waiver may also be implied from the conduct of the employer, for example, where it is provided that the employer shall be entitled to deduct liquidated damages as and when they become due and if he does not so deduct them, then the employer will lose his right to claim the liquidated damages which have accrued.[89]

[88] [1906] 2 Hudson's BC (4th edn) 398

[89] *Co* [1865] 11 Jur NS 681; See also *Laidlaw v Hasting Pier Co* [1874] 2

CHAPTER 5

LIQUIDATED DAMAGES IN MALAYSIA

CHAPTER 5

LIQUIDATED DAMAGES IN MALAYSIA

5.1 Introduction

In Malaysia, the law on liquidated damages is governed by the Contracts Act 1950. Section 75 of the Contracts Act deals with the effect of a "sum named" in a contract which is payable in cases of breach of contract. The most important difference between section 75 and the UK common law is that in Malaysia, 'there is no difference between penalty and liquidated damages.'[90] However, the common law principles on other aspects of the law of liquidated damages, unless expressly agreed otherwise, are generally applicable to the construction contracts in Malaysia.

5.2 Section 75 Contracts Act 1950 – Legislative History

The Malaysian Contracts Act 1950 (MCA) is substantially in pari material with the Indian Contract Act 1872 (ICA) which is largely a codification of the then existing English common law and rules of equity. Section 75 MCA is, word for word, identical to Section 74 of the ICA.

Section 74 ICA as it stood before amendment in 1899 was applied only to those stipulations of enhanced interest when a sum was named in the contract as the amount to be paid in case of breach. It was held not to apply in situation for increased interest when

the higher rate commenced from the date of default. The section, after amendment, brings within its operation all the stipulations in the nature of a penalty, as seen from the words "any other stipulation by way of penalty." The amendment to the section was made in 1899 and the Explanation ('A stipulation for increased interest from the date of default may be a stipulation by way of penalty') together with the Illustrations (d), (e), (f) and (g) were inserted. The result, therefore, is that in the case of a stipulation for higher rate of interest from the date of default equitable relief will now be granted whenever such a situation is penal under the provisions of the Section.

5.3 Rationale of Section 75 Contracts Act 1950

Under the English common law, a genuine pre-estimate of damages by mutual agreement is regarded as liquidated damages and has a binding effect between the parties. On the other hand, a stipulation in a contract in *terrorem* is a penalty and the court will refuse to enforce it but the employer may sue for general damages that he can prove. Whether it is an enforceable liquidated damages or unenforceable penalty is a question of law and is to be determined by the court. The line between these two is a fine one and it creates uncertainty in a contract.

Section 75 MCA (or section 74 ICA) was enacted to cut across the web of rules and presumptions under the English common law by enacting a uniform principle applicable to all stipulations naming amounts to be paid in case of breach or stipulation by way of penalty. The section introduces equitable jurisdiction by allowing the court to grant reasonable compensation.

Section 75 of the Contracts Act 1950 provides:

"When a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled, whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for."

In *Linggi Plantations Ltd v Jagatheesan*,[91] Lord Hailsham LC said:

> "S74[ICA] was intended to cut through the rather technical rules of English law relating to the liquidated damages and penalties, and to apply in substance the equitable rule to all cases whether the sum provided in the contract was in substance a penalty or a genuine pre-estimate of the damage likely to be suffered ..."

In *Maniam v The State of Perak*,[92] Thompson J opined that "in this country, there is no difference between penalty and liquidated damages." His Lordship further held that: "in brief, in our law, in every case if a sum is named in a contract as the amount to be paid in case of breach, it is to be treated as a penalty."

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[91] [1972] 1 MLJ 89. Similar view was also held by the Supreme Court of India in *Fateh Chand v Balkishan*

5.4 Scope of Section 75 Contracts Act 1950

5.4.1 Scope

Almost all the standard forms of construction contract commonly used in Malaysia provide a clause on liquidated damages to be paid to the Employer for non-completion of works.[93] The clause provides the machinery whereby the employer and the Contractor can agree in advance the damages to be payable by the Contractor if he fails to complete by the date for completion or within any extended time. However, the enforceability of this provision is subject to section 75 Contracts Act 1950.

The effect of section 75 is that any stipulated sum in a contract which is meant to be liquidated damages clause, even though it is a genuine pre-estimate of the damages, cannot be recovered simpliciter unless the court is satisfied that it is a reasonable sum. In other words, no provision in a contract by way of liquidated damages in Malaysia is recoverable in a similar manner as it would be under English law, as in every case, the court has to be satisfied that every sum of money payable by way of liquidated damages is reasonable.

Privy Council in the Indian case of *Bhai Panna Singh v Bhai Arjun Singh*[94] explained the scope of section 74 ICA as follows:

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[93] For example Clause 22 of PAM 1998 provides " If the Contractor fails to complete the Works by the Date for Completion or within any extended time fixed under Clause 23.0 or sub-clause 32.1 (iii) and the Architect certifies in writing that in his opinion the same ought reasonably so to have been completed, then the Contractor shall pay to the employer a sum calculated at the rate stated in the Appendix as Liquidated Ascertained Damages (LAD) for the period from the Date for Completion or any extended date where applicable to the date of Practical Completion. The employer may deduct such sum as a debt from any monies due or to become due to the Contractor under this Contract". Similar liquidated damages clause is [illegible] under Clause 40 of the JKR Form 203A.

"The effect of Section 74, Contract Act of 1872, is to disentitle the plaintiffs to recover simpliciter the sum of Rs. 10,000 whether penalty or as liquidated damages. The plaintiffs must prove the damages they have suffered. The only evidence of loss is that the loss on resale by Rs. 1,000. As to the scope of Section 74 the following principle was laid down: 'Where loss in terms of money on account of breach of contract can be ascertained in actual loss. If, it fails to prove the actual loss in such a case it cannot be held entitled to the sum named in the agreement simply because such a sum is mentioned therein. It is only in those cases where the Court is unable to assess the actual loss that the sum mentioned in the agreement may be taken into consideration provided the sum named be regarded as a genuine pre-estimate of damages or otherwise be a reasonable compensation for the breach. If on the other hand, Court comes to the conclusion that the amount so fixed was in terrorem, excessive or extravagant, the plaintiff would be entitled to only such sum as may appear to the Court reasonable."

From the wording of section 75, the section provides for the measure of damages in two classes of case namely:

1. Where the contract names a sum to be paid in case of breach; and

2. Where the contract contains any other stipulations by way of penalty

When measuring damages, following conditions need to be complied with:

1. The innocent party is entitled to receive reasonable compensation

2. It does not matter whether or not actual damage or loss is proved to have been caused thereby

3. The reasonable compensation shall not exceed the sum or penalty stipulated in the contract.

5.4.2 Liquidated Damages and Penalty under Malaysian Law

So far as the law in Malaysia is concerned, contrary to the English common law, there is no qualitative difference in the nature of "liquidated" and "unliquidated" damages as section 75 eliminates the somewhat elaborate refinement made under the common law between liquidated damages and penalty. Thus by virtue of section 75, the claim for liquidated damages stands on the same footing as a claim for unliquidated damages. For unliquidated damages, it does not give rise to a debt until the law adjudicates upon and damages are assessed pursuant to section 74 Contracts Act 1950. The defaulting party does not incur instantly a financial liability when he breaches the contract nor does the innocent party become entitled to claim a debt. The innocent party is only entitled to sue for damages and have them adjudicated upon.[95] The court must determine what is reasonable compensation not exceeding the amount named in the contract.[96]

In *Hsu Seng v Chai Soi Fua*,[97] the court held:

> "The distinction between liquidated damages and penalty has ceased to be of great legal importance because the result in either case is that the court must determine reasonable compensation".

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[95] *Union of India v Raman Iron Industries*, AIR 1974 SC 1265

[96] In *Fateh Chand v Balkishan Das* AIR 1963 SC 1405, the Supreme Court of India held: "[S74] merely declares the law that notwithstanding any terms in the contract for determining the damages or proving for forfeiture of any property by way of penalty, the court will award to the party aggrieved only reasonable compensation not exceeding the amount named or penalty stipulated."

[97] [1990] 1 MLJ 300, 303; See also *Chung Syn Kheng Electrical Co. Bhd v Regional Construction Sdn Bhd* [1987] 2 MLJ 763.

5.5 Section 74 and Section 75

Section 74 Contracts Act 1950 provides for compensation for loss or damage caused by breach of contract. It lays down that, when a contract has been broken, the party who suffers by such a breach is entitled to receive compensation for any loss or damage caused to him thereby, which naturally arose in the usual course of things from such a breach, or which the party knew when they made the contract, to be likely to result from the breach of it. Section 75 provides for breach of contract where penalty is stipulated for or a sum is named and lays down that when a contract has been breached, the injured party is entitled to receive reasonable compensation not exceeding the named sum.

Both these sections provide for reasonable compensation, and section 75 contemplates, that the maximum reasonable compensation will be the amount named in the contract, but not more, even though according to section 74, the amount of compensation may exceed the sum named. Section 74 provides for the test to determine what amounts to reasonable compensation but it is silent in section 75. Under section 75, where it is not possible for the court to assess the compensation arising from the breach, the amount stipulated in the contract, if it is found to be reasonable and genuine pre-estimate of the loss or damage suffered by the injured party, could be taken into consideration as a measure of reasonable compensation. But, if the amount stipulated is either excessive or extravagant or unconscionable the court would not admit that amount as representing reasonable compensation. In such a case the plaintiff must prove the loss suffered by him. The court has jurisdiction to award only a reasonable sum but not exceeding the amount stipulated in the contract, and its duty is not to enforce the penal clause but only to award reasonable compensation.[98]

[98] *P. Chandrasekhar v Union of India* [1984] 2 Audh WR 205

Section 75 does not overlap or extend section 74. For the application of section 75, there must either a sum named in the contract to be paid in case of breach of contract or the contract should contain any other stipulation by way of penalty.[99]

The question, whether a clause in a contract is merely a pre-estimate of reasonable compensation for breach of contract, or states a penal sum, is a question of fact to be construed by the court, which must proceed to determine the real nature of the transaction, taking into consideration the intention of the parties as evidenced by the language of the contract and the circumstances of the case, which must be taken as a whole and viewed at the time the contract was made.[100]

5.6 Meaning of Words and Phrases of Section 75

5.6.1 A Sum is Named

There may be two situations whereby a sum is named in the contract as the amount to be paid in case of such a breach.

(a) The sum named is a genuine pre-estimate of the damage likely to be caused by the breach. The measure of damages would be the same as is provided by section 74, unless the sum named in the contract is less than that recoverable under section 74, in which case the sum named is the maximum amount which can be awarded.

[99] *Union of India v Vasudeo*, AIR 1960 Pat. 87
[100] *Dunlop Pneumatic Tyre Co. v New Garage Motor Co.* [1915] AC 79

(b) The sum named is not a genuine pre-estimate of the loss as it is unreasonable or extravagant or unconscionable. The court will award reasonable compensation

However, if the losses are difficult to be determined, the courts strongly incline to accept the named sum as reasonable and to enforce it.[101]

5.6.2 Stipulation by Way of Penalty

Where a stipulated sum is in the nature of a threat held over the other party in terrorem, for example as a security to the promisee that the contract will be performed, then the sum is a 'stipulation by way of penalty'. In such a case, the stipulated sum will not be enforced and only reasonable compensation, if any, will be awarded.[102]

5.6.3 Reasonable Compensation

The wording of section 75 clearly gives a wide discretion to the court in the assessment of damages. The only restriction is that the court cannot decree damages exceeding the amount previously agreed upon by the parties. As the expression used is 'reasonable compensation' it necessarily implies that discretion so vested must be exercised with caution and on sound principle and in accordance with the law.[103] The words 'reasonable compensation' means compensation payable under section 74 of Contracts Act 1950. In other words, in assessing reasonable compensation, the court has to take into consideration the actual loss or damage suffered by the plaintiff.

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[101] *Cellulose Acetate Silk Co Ltd v Widnes Foundry* [1933] AC 20 (HL)
[102] *Mitchel Habib v Sheikh Suleiman*, AIR 1941 PC 101 (PC)
[103] *PC Muthu v Maruthanayagam*, AIR 1930 Mad 428

If the court is satisfied that the said sum is a genuine pre-estimate and that it represents a reasonable sum for the loss suffered, it may order the said sum to be paid as damages. In such a case, it must be emphasized that the court is not recognizing the stipulated sum as liquidated damages as understood under English law but rather recognizing the sum as a penalty and thereby giving effect to it as a reasonable compensation for the los suffered by the plaintiff.

On the other hand, if the court is of the view that the said sum is a penalty, then the court will only award reasonable compensation and the compensation is to be assessed in the ordinary way, subject to the sum named as a maximum, which represents the plaintiff's actual loss.

Jurisdiction of the court to award compensation in case of breach of contract is unqualified except as to the maximum stipulated; but compensation has to be reasonable and that imposes upon the court duty to award compensation according to settled principles. No compensation can be awarded when in consequence of the breach no legal injury at all had resulted.

However despite the clear wordings, in some occasions, the Malaysian courts had interpreted section 75 as requiring proof by the plaintiff for the damages suffered.

The court in *Wearne Brothers (M) Ltd v Jackson*[104] and *Wee Wood Industries Sdn Bhd v Guannex Leasing Sdn Bhd*[105] have held that the plaintiff cannot claim *simpliciter* a stipulated sum fixed in the contract and that he must prove the loss suffered by him.

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[104] (1966) 2 MLJ 155
[105] (1990) 2 CLJ 1060

The Federal Court in *Selva Kumar a/l Murugiah v Thiagarajah a/l Retnasamy*[106] made a landmark decision on this issue and held that if the damages are not too remote and could be assessed by settled rules, the plaintiff must prove the actual loss suffered. As we will see later, there are many cases after *Selva Kumar* which tried to circumvent the Federal Court decision by either distinguishing *Selva Kumar* or argued that the case fell in the exception category.

5.6.4 Whether or Not Actual Damage is Proved to Have Been Caused

(a) Need to Prove Quantum of Damages

This is the most controversial part of section 75 as the courts seem to adopt different approaches on the issue of proving the damages. On a plain reaching the phrase 'whether or not actual damage or loss is proved to have been caused thereby' seems to endorse the very basis of a liquidated damages clause, ie. recovery without proof of actual loss. However, Lord Atkin in *Bhai Panna Singh v Bhai Arjun Singn*[107] held:

> "The effect of section 74 of the Contracts Act of 1872 is to disentitle the plaintiffs to recover simpliciter the sum of Rs10,000, whether the penalty or liquidated damages. The plaintiff must prove the damages they have suffered."

The Indian Supreme Court in two leading cases adopted the view of Lord Atkin that a plaintiff must prove the actual damage, ie. he must prove the damages for the actual loss suffered, despite the clear words in the phrase 'whether or not actual damage or loss is proved to have been caused thereby'.

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[106] [1995] 1 MLJ 817
[107] *Supra* at 94

The first of these two cases is *Fateh Chand v Balkishan Dass*[108] where the court held that reasonable compensation should be awarded 'to make good loss or damage which naturally arose in the usual course of things or which the parties knew when they made the contract, to be likely to result from the breach.' The court applied the test for measurement of damages proposed in the celebrated case of *Hadley v Baxendale*[109] which has also been codified in section 73 of the Indian Contract Act (in pari material to section 74 of the Malaysian Contracts Act 1950).

The other case is *Maula Bux v Union of India*[110] of India where the court affirmed *Fateh Chand* and held that the plaintiff must prove the loss. It was held:

> "When loss in terms of money can be determined the party claiming compensation must prove the loss suffered by him."

The Court also stated that the phrase in question was intended to cover two kinds of contracts. The first kind is where the court would find it very difficult to assess such reasonable compensation and the second kind is what the court could assess such reasonable compensation with settled rules.

In Malaysia, the view of Lord Atkin was adopted by the High Court in *Wearnes Brothers (M) Ltd v Jackson*[111] where it was held that the plaintiff must prove the damages they had suffered. The court however, in relying on Lord Atkin's statement was clearly wrong when he said 'the plaintiff must prove the damages they have suffered unless the sum named is a genuine pre-estimate.' There is no support for the view that a plaintiff may recover a

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[108] AIR 1963 SC 1405

[109] *Supra* at 31

[110] AIR 1970 SC 1955; [1970] 1 SCR 928. See also *Pravpdayal Agarwala v Ram KumarAgarwala,* AIR 1956 Cal 41; *Moolchand v Chand & Co,* AIR 1947 Lah 12

[111] *Supra* at 104

genuine pre-estimate without proof of any actual loss. This criticism was also shared by Peh Swee Chin FCJ in the Federal Court case of *Selva Kumar a/l Murugiah v Thiagarajah a/l Retnasamy*.[112]

(b) Two Interpretations in Malaysia

The seemingly clear wordings in the phrase 'whether or not actual damage is proved to have been caused' have created much controversy in Malaysia judicial decisions. The courts have adopted two different approaches with entire different interpretations. Although the Federal Court in *Selva Kumar v Thiagarajah*[113] had made a landmark decision on the correct interpretation, the controversies did not seem to come to a rest as the courts in subsequent cases are still adopting different approaches.

- **Literal Interpretation**

The clear wordings of section 75 show that in every case of breach of contract, the person aggrieved by the breach is not required to prove the actual loss or damage suffered before claiming compensation and the court is competent to award reasonable compensation in case of a breach even if no actual damage is proved to have been suffered in the consequence of the breach of the contract. Therefore, on a plain reading, this phrase seems to endorse the very basis of a liquidated damages clause, ie, recovery without proof of actual loss.

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[112] *Supra* at 106
[113] *Ibid*

Abdul Malik Ishak J in *Yap Yew Cheong v Dirga Niaga (Selangor) Sdn Bhd*[114] held "in construing section 75 of the Contracts Act 1950, I must accord it a literal, plain and ordinary interpretations ... Consequently, I must give effect to the said clause entered by the parties thereto". His Lordship continued to explain the rules of statutory interpretation.

Similarly in *Lebbey Sdn Bhd v Tan Keng Hong*[115] and *Syarikat Ong Yoke Lin Sdn Bhd v Giant Cash and Carry Sdn Bhd*,[116] the courts adopted literal interpretation despite the decision of *Selva Kumar*.

In India, cases that adopted literal interpretation are *State of Rajasthan v Chandramohan*[117] and *Anand Construction Works v State of Bihar*.[118]

- **Restricted Construction**

The leading case that adopted restricted interpretation of the phrase is the Federal Court case of *Selva Kumar v Thiagarajah*.[119] Peh Swee Chin FCJ held that the adoption of literal interpretation of section 75 would seem to be beyond the object of the section, viz the abolition of the distinction between the penalty and liquidated damages, and also it will produce a most unreasonable result in that it will change the existing law which is that a plaintiff ought to prove damages. His Lordship then held that the literal construction should not be strictly adhered to and the words in question should be given a restricted or limited construction. That means, the qualifying words in section 75 'whether or not actual damage or loss is proved to have been caused thereby' are limited or restricted to those

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[114] [2005] 7 MLJ 660
[115] [2001] 7 MLJ 521
[116] [2000] 4 CLJ 757
[117] AIR 1971 Raj. 229
[118] AIR 1973 Cal. 550
[119] *Supra* at 106

cases where the court would find it difficult to assess damages for the actual damage or loss as opposed to all other cases, where a plaintiff in each of them will have to prove the damages or the reasonable compensation for the actual damage or loss in the usual way.[120]

The court further held that in cases where damages for actual loss is not too remote and the damages could be assessed by settled rules, the plaintiff must prove the actual loss suffered. In reaching the conclusion, His Lordship relied on the Privy Council decision in *Bhai Pannah Singh v Bhai Arjun Singh*[121] and two Indian Supreme Court decisions namely *Fateh Chand v Balkishen Das*[122] and *Maula Bux v Union of India.*[123]

Selva Kumar was later followed in *Reliance Shipping & Travel Agencies v Low Ban Siong,*[124] *Realvest Properties Sdn Bhd v The Co-operation Central Bank Ltd;*[125] *Joo Leong Timber Merchant v Dr Jaswant Singh*[126]; *Pembinaan Sima Sdn Bhd v Low Lai Seng Holdings Sdn Bhd*[127] and *Keen Builders Sdn Bhd v Utara Dua (M) Sdn Bhd.*[128]

(c) Need to Prove Legal Injury

Section 75 merely dispenses with proof of 'actual loss or damage", however, it does not justify the award of compensation when in consequence of the breach no legal injury at all has been suffered. Therefore the plaintiff is still under a duty to adduce evidence to prove

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[120] *Reliance Shipping & Travel Agencies v Low Ban Siong* [1996] 2 MLJ 543 (CA) at 547, per Siti Norma Yaakob JCA
[121] *Supra* at 108
[122] *Supra* at 110
[123] AIR 1970 SC 1955
[124] (1996) 2 MLJ 543, CA
[125] (1996) 3 CLJ 823, FC
[126] (2003) 5 MLJ 116
[127] (1998) 1 CLJ 159
[128] (1998) 2 CLJ 256

that he did suffer legal injury and actual loss, though he is not necessary to prove the actual quantum of damages.[129]

5.7 Proving Damages

The Indian Court in *State of Kerala v United Shippers and Dredgers Ltd*[130] provided an interesting historical background as to why the damages need to be proved despite the clear wordings of the phrase. In this regard, the court in that case persuasively argued that the issue of actual damages, perforce, to arise in the context of a penalty clause at common law. Simply because such a clause being unenforceable, the court had then to proceed to determine the actual damages suffered. Such an enquiry could not, of course, be necessary in the context of a liquidated damages clause. As, however, section 75 was intended to do away with the distinction between liquidated damages and penalties altogether, the issue of actual damage ceased to be relevant in so far as the latter was concerned. In this situation, section 75 dispenses with such proof of the extent of real or actual or factual loss or damage, but provides for grant of reasonable compensation subject to the limit of the amount stipulated in the contract itself.[131]

However the court proceeded to point out that this did not mean that where actual damage or loss could in fact be proven on the facts of the case concerned, such damage or loss was irrelevant. The court succinctly held that:

> "He [the plaintiff] *need not* prove in an exact manner the extent of the real loss or damage suffered by him or the loss or damage suffered by him in fact. *However, if*

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[129] See *Fateh Chand v Balkishan Das* AIR 1963 SC 1405; *State of Kerala v United Shippers and Dredges Ltd* AIR 1982 Kerala 281

[130] AIR 1982 Kerala 281

[131] *Ibid* at 286

he proves it, that will certainly help the Court to arrive at the proper compensation. Even if he fails to prove it, court cannot throw out his case on that ground, but must proceed to assess reasonable compensation which is to be awarded to him, on the materials before the Court and subject to the limit of the amount stipulated in the contract." [emphasis added]

The court further held:

"The *best measure* of reasonable compensation would of course be the extent of actual loss or damage sustained. If the extent of actual loss or damage sustained is capable of being proved that provides a *safe guide* for the Court to determine the quantum of reasonable compensation. If quantification of loss or damage is not possible, the party who has suffered on account of the breach is not without remedy. He can still request the Court to assess reasonable compensation on the materials available and award the same to him. The words in [section 75 MCA] 'whether or not actual damage or loss is proved to have been caused thereby' have been employed to underscore the departure deliberately made by Indian Legislature from the complicated principles of English Common Law and also to emphasize that reasonable compensation can be granted *even* in a case where extend of *actual loss* or damage is *incapable of proof* or *not proved*. That is why [section 75] of the Act deliberately states that what is to be awarded is reasonable compensation." [emphasis added]

5.8 *Selva Kumar*

The decisions of *Selva Kumar*, in summary, are as follow:

(a) In Malaysia, there is no distinction between liquidated damages and penalties as understood under English law, in view of section 75 of the Contracts Act 1950 which provides that in every case the court must determine what is the reasonable compensation, whether or not actual damages or loss is proved to have been caused thereby.

(b) If the stipulations, whether named sum or by other stipulations, are penalty, then the court will not enforce the agreement but to award reasonable compensation.

(c) If the stipulations are not penalty, then there are two possible scenarios:

  (i) Where there is no known measure of damages employable and yet the evidence clearly shows some real loss inherently and such loss is not too remote; then the court ought to award not nominal damages, but instead, substantial damages not exceeding the sum so named in the contractual provision, a sum which is reasonable and fair according to the court's good sense and fair play.

  (ii) In case where there is inherently any actual loss from the evidence or nature of the claim and damages for such actual loss is not too remote and could be assessed by settled rules, any failure to bring in further evidence or to prove damages in accordance with the settled principles in *Hadley v Baxendale*[132] for such actual loss, will result in the refusal of the court to award such damages, despite the words in question.

The above decision departed from the clear wordings of section 75. Firstly, section 75 does not require the plaintiff to prove any damages, neither remoteness nor causation of

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[132] *Supra* at 31

damages. In *Selva Kumar*, the plaintiff is required to prove the damages if they can be proved by settled rules. Secondly, section 75 stipulates that the court will assess the damages whereas in *Selva Kumar*, the plaintiff would need to prove quantum of damages claimed, otherwise the court would refuse to award any damages.

5.9 Cases after *Selva Kumar*

There are quite a number of cases decided after *Selva Kumar* which did not follow the decision despite it is a Federal Court judgment. The main argument put forward is that the said liquidated damages clause was mutually agreed and by the doctrine of freedom of contract and sanctity of contract, the clause should be given the effect that was intended to be.

The Court of Appeal in *Silver Concepts Sdn Bhd v Brisdale Rasa Development Sdn Bhd* [133] held that:

> "It is now established that a party who attacks a liquidated damages clause as a penalty is in fact asking the court to relieve him from his contractual obligations which he had freely undertaken in exchange for good consideration. The courts would therefore generally preserve the sanctity of the contract freely entered into by the parties."

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[133] (2005) 4 MLJ 101. See also *Maxisegar Sdn Bhd v Silver Concept Sdn Bhd* [2005] 5 MLJ 1; *Pusat Damansara Sdn Bhd v Yap Han Soo & Sons Sdn Bhd* [2000] 1 MLJ 513. Abdul Malik Ishak J in *Yap Yew Cheong v Dirga Niaga (Selangor) Sdn Bhd* [2005] 7 MLJ 660 said: "That the parties are entitled to freely enter into an agreement or bargain as equals cannot be doubted. It is not the duty of the court to dictate the terms of the contract to the parties. It is the parties themselves that should decide what the terms that they should be bound to. This approach is consistent with the idea that contracts should be made by the parties themselves. It is an approach that is known as the freedom of choice. It is certainly consonant with the concepts of a free market economy and the spirit of competition."

It appears that cases after *Selva Kumar* were decided in disarray manners where some followed the decision in *Selva Kumar* faithfully due to the doctrine of *stare decisis*, some distinguished the facts and refused to follow *Selva Kumar*; in some cases, it was decided that the facts of those cases fell into the exceptions (ie. the cases that there is no known measure of damages) whilst there are also cases which did not cite the *Selva Kumar* decision at all (eg. the two *Silver Concept* cases).

For ease of reference, the cases are categorized into following types of issue:-

5.9.1 Penalty Interest for Late Delivery of Houses

These types of cases involve the penalty interest payable by the vendor to the purchaser of property and the penalty interest was agreed by all parties in the Sale and Purchase Agreement (SPA).

(a) No Need to Prove

Shortly before *Selva Kumar* was decided by the Federal Court, the High Court in *Xavier Kang Yoon Mook v Insun Development Sdn Bhd* [134] held that: "the language employed in Clause 18(2) of the SPA (ie. the liquidated damages clause) is clear and unambiguous and its natural meaning relate to the right of the purchasers to rescind and sue immediately for liquidated damages if the recalcitrant developer failed to deliver the house within 24 months from the date of the SPA. In construing Clause 18(2), one must examine the language employed therein and one must not be influenced by other unnecessary conditions." Section 75 was not referred to.

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[134] (1995) 2 CLJ 471

In *Lebbey Sdn Bhd v Tan Keng Hong*,[135] Faiza Tamby Chik J held that if parties have agreed to liquidated damages (12% per annum); then if one party breaches the SPA, the complaining party will be entitled to reasonable compensation. The court should interpret section 75 by giving it a literal, plain and ordinary interpretation. A contrary interpretation would be against the express provisions of the Section.

His Lordship criticized the decision in *Selva Kumar* and said:

> "I am of the opinion that to limit the application of section 75 of the Act to cases where damages are difficult to assess is illogical and cannot be accepted."

In *Leong Lai Kuen v Sentul Murni Sdn Bhd*,[136] James Foong J (as he then was) adopted a strict literal interpretation of section 75 and held that the plaintiff, under the law, is only entitled to receive "reasonable compensation not exceeding the amount so named." To determine what was reasonable the court has to decide and the plaintiff was not required to prove the losses. His Lordship then referred to the Senior Assistant Registrar to assess the reasonable compensation to be awarded. *Selva Kumar* was not referred to in this case.

The High Court in *Brisdale Recources Sdn Bhd v Law Kim*,[137] distinguished the facts from *Selva Kumar* and opined that the defaulting party is bound by the terms of the Agreement and is estopped from breaching the same. The defaulting party thus cannot rely on the provisions of section 75 of the Act to avoid paying the respondents the agreed liquidated damages. The court then held that the plaintiff need not prove its loss pursuant to section

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[135] *Supra* at 115
[136] (2004) 5 CLJ 25
[137] (2004) 6 MLJ 76

75 of the Act as Clause 22 (liquidated damages of 10% per annum) in SPA between the parties is mandatory in nature.

(b) Need to Prove

In *Pembinaan Sima Sdn Bhd v Low Lai Seng Holdings Sdn Bhd*,[138] RK Nathan JC adopted the principles in *Selva Kumar* and held that the plaintiff need to prove the damages suffered.

5.9.2 Penalty Interest on Default of Payment

This arises when a party is required under an agreed term, to pay additional or penalty interest upon default of payment.

(a) No Need to Prove

In *Pusat Bandar Damansara Sdn Bhd v Yap Han Soo & Sons Sdn Bhd*,[139] the Court of Appeal held that the penalty interest was an agreed term and not fixed unilaterally and it could not have been that excessive. Therefore, the said penalty interest is not caught by section 75.

The High Court in *Kok Swee Chin v General Factoring & Credit Sdn Bhd*[140] distinguished the facts from *Realvest Properties Sdn Bhd v The Co-operative Central Bank Ltd*[141] and opined that the late payment charges is a genuine pre-estimate of the defendant's loss for

[138] *Supra* at 127
[139] [2000] 1 MLJ 513

breach of contract (in servicing the installments late). It was by no means exorbitant, harsh or unconscionable but serves as a "reasonable compensation".

In *Malaysia Building Society Bhd v Univein Sdn Bhd*,[142] Low Hop Bing J (as he then was) held that the penalty interest of 9.5% per annum is reasonable within the meanings of section 75 and no proof is needed.

In *Silver Concept Sdn Bhd v Brisdale Rasa Development Sdn Bhd*[143] and *Maxisegar Sdn Bhd v Silver Concept Sdn Bhd*,[144] the case facts were similar and were decided by the same panel of judges in the Court of Appeal. In these two cases, the court relied on *Pusat Bandar Damansara Sdn Bhd v Yap Han Soo & Sons Sdn Bhd*[145] and three other cases from Singapore, Canada and Australia in reaching the conclusion. The court held:

(1) The defendant has failed to demonstrate to the court that the agreed liquidated damages in the Agreement is extravagant, exorbitant or unconscionable in relation to the loss likely to be suffered and is therefore a penalty clause;

(2) The defendant and plaintiff had both freely bargained and agreed upon to the formula of damages stipulated in the Agreement;

(3) Therefore, the agreed liquidated damages provision in the Agreement is not a penalty clause and the court would preserve the sanctity of the contract freely entered into by the parties.

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[142] (2002) 7 MLJ 276
[143] *Supra* at 133
[144] [2005] 5 MLJ 1
[145] *Supra* at 139

It is interesting to note that the court did not refer to *Selva Kumar* in reaching the decision.

Lately in *Alliance Bank Malaysia Bhd v Chan Teik Huat*,[146] the court opined that section 75 Contracts Act 1950 was not applicable as the increase in the rates of interest was contractually provided for. The default interest rate of 1% is not excessive as it would meet the requirement of genuine pre-estimate contractually agreed by the parties. The court then held that the default interest rate is far from being exorbitant and is not subject to proof as alleged.

(b) Need to Prove

In *Realvest Properties Sdn Bhd v The Co-Operative Central Bank Ltd*,[147] Peh Swee Chin FCJ (the same judge who presided over *Selva Kumar*) followed *Selva Kumar* and held that the default interest clause in the Agreement is a penalty clause as it runs from the date of the Agreement and not from the date of default and hence it is irrecoverable. As the plaintiff failed to prove the damages (following the case of *Selva Kumar*), the court refused to make any award with regards to the penalty interest.

In *Malayan Banking Bhd v Chong Hin Trading Co Sdn Bhd*,[148] the High Court, referring to *Realvest Properties* and held that the default interest, by virtue of section 75, is required to be proved. Upon appeal, the Court of Appeal did not rule on this point as the defendant did not appeal against this part of decision.

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[146] [2006] 7 MLJ 242
[147] *Supra* at 125
[148] (2001) 6 MLJ 223

5.9.3 Liquidated Damages in Construction Contracts

There are very few cases pertaining to the liquidated damages as most construction disputes are referred for arbitration and the arbitrator shall award liquidated damages based on his own assessment.

(a) No Need to Prove

In *Sakinas Sdn Bhd v Siew Yik Hau*,[149] Abdul Aziz J followed *Selva Kumar* but held that a case of delay in completion such as the present case should be treated as belonging to the first class of cases (ie. cases where there is no known measure of damages employable) which does not require proof of actual damage of loss. His Lordship then concluded that 10% per annum liquidated damages is not excessive; it is an acceptable benchmark in the business community and constitutes reasonable compensation.

In *Hock Huat Iron Foundry v Naga Tembaga Sdn Bhd*,[150] the High Court opined that the liquidated damages of RM2,000 per day for the delay is a genuine pre-estimate of damage and not a penalty. In addition, the plaintiff agreed to the liquidated damages clause when he entered into the Contract. It was held that the sum of RM2,000 per day is reasonable having regard to the total investment put up by the defendants and their financial commitments in building the factory. The Court of Appeal later reversed on this point, but on different grounds.[151]

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[149] (2002) 5 MLJ 497

[150] (1999) 1 MLJ 65

[151] The Court of Appeal held that there was no delay in completion as the contract was at large and consequently no liquidated damages shall be imposed.

In *Keen Builders Sdn Bhd v Utara Dua (M) Sdn Bhd*,[152] the respondent is the main contractor and had agreed with the appellant (a housing developer) to build 224 units of double storey houses. The liquidated damages for delay in completion is RM17,080 per day. RK Nathan J has this to say:

> "I hold that in a case such as this where there has been a delay in the completion of the project, with so many variable factors to be considered including the fluctuation of the Ringgit, the parties' consensus of having mutually agreed upon a figure, must fall squarely within that 'restrictive and limited" class of cases envisaged by the Federal Court in *Selva Kumar*."

The court held that the plaintiff did not have to prove the liquidated damages as agreed.

In *Yap Yew Cheong v Dirga Niaga (Selangor) Sdn Bhd*[153] the court held that the said liquidated damages Clause (12% per annum) was not a penalty clause and that the plaintiffs were not required to prove the losses. The court further held that even if the said clause was said to be a penalty clause, the plaintiffs did not have to prove the losses because the so called penalty clause was a term of an agreement entered into mutually between the plaintiffs and the defendant and thus binding and enforceable against both parties.

Lately the High Court in *Mohd Omar Lopez v Emily Batu Bagang*[154] also upheld a liquidated damages clause in a construction contract without having the plaintiff to prove actual losses.

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[152] *Supra* at 128
[153] *Supra* at 114
[154] [2008] 1 LNS 265

(b) Need to Prove

In *Joo Leong Timber Merchant v Dr Jaswant Singh*,[155] the court followed *Selva Kumar* faithfully and held that the liquidated damages clause of RM25 for each day's delay was undoubtedly a clause falling within section 75 and is required to be proved.

5.9.4 Summary

From the above cases, it appears that the courts are moving away from *Selva Kumar*, notwithstanding that it is a Federal Court decision.

In construction contracts, it appears that the courts are more likely to uphold the liquidated damages clause as it falls within the exception (ie. cases where there is no known measure of damages employable) as envisaged by the Federal Court in *Selva Kumar*.

Abdul Malik Ishak J in *Yap Yew Cheong* had this to say:

> "Will *Selva Kumar*, decided in the context of the sale of a medical practice, be rigidly applied by the courts in Malaysia in a construction dispute? It seems that the courts are moving away from *Selva Kumar* and *Sakinas* is a classic example of it. The learned judge in the person of Abdul Aziz Mohamed J (now JCA) in deciding *Sakinas* was ever ready to consider the issue of delays in construction projects as a species of breach for which 'no known measure of damages is employable'. That is certainly laudable."

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[155] *Supra* at 126

The recent decisions of the Court of Appeal in the two *Silver Concept* cases certainly had shattered the tranquility since the decision of *Selva Kumar*. Nevertheless, *Selva Kumar* still remains as good law today and a plaintiff is required to prove his actual losses if such losses could be assessed by settled rules.

5.10 How to Circumvent Section 75 and *Selva Kumar*

5.10.1 Contracting Out of the Statute

Can we contract out of section 75?

In *Ooi Boon Leong v Citibank NA*,[156] the Privy Council held that if freedom of contract is to be curtailed in relation to a particular subject matter, the prohibition should be expressed in the statute and not left to the legislature to be picked out as an implication based upon sections dealing with different subject matters. Based on this decision, it can be said that contracting parties should be able to expressly contract out of the provisions of the Contracts Act 1950.

Ooi Boon Leong was later applied in *Isito Electronics Sdn Bhd v Teh Ah Kian & Anor*[157] where Ramli Ali J held in a case concerning section 104 of the Contracts Act 1950 that "the said section can by agreement be contracted out by the parties".

In *Yap Yew Cheong v Dirga Niaga (Selangor) Sdn Bhd*,[158] Abdul Malik Ishak J made an orbiter remark on the possibility of contracting out of section 75:

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[156] (1984) 1 MLJ 222
[157] [2004] 3 CLJ 272
[158] *Supra* at 126

"As I see it, the only way to avoid the impact of *Selva Kumar* is to vary the legal consequences spelt out by *Selva Kumar* in the context of s. 75 of the Contracts Act 1950. It can be done provided both the parties are agreeable to circumvent the rigours of *Selva Kumar*. What both the parties should agree to would be:

(1) that they would agree to redeem the value of the liquidated damages to be the injured party's actual loss; and

(2) that they should agree to dispense with the need to prove the injured party's actual loss."

However, in *Johore Coastal Development Sdn Bhd v Constrajaya Sdn Bhd*,[159] Gopal Sri Ram JCA raised the issue of whether parties do an agreement may contract out of section 75 but expressly refused to decide on it.

From the above decisions, it can be concluded that it is possible to contract out of section 75 of the Contracts Act 1950 and the courts are likely to give effect to such clause.

It is interesting to note that some of standard forms commonly used to Malaysia have endeavoured to contract out of section 75 by providing that the Employer, by entering into the contract, is not required to prove the losses.[160]

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[159] [2005] 2 CLJ 914

[160] For example, clause 22.2 of PAM 2006 provides: "The Liquidated Damages stated in the Appendix is a genuine pre-estimate of the loss and/or damage which the Employer will suffer in the event that the Contractor is in breach of Clause 21.0 and 22.0. The parties agree that by entering into the Contract, the Contractor shall pay to the Employer the said amount, if the same becomes due without the need for the Employer to prove his loss and/or damage unless the contrary is proven by the Contractor."

5.10.2 No Liquidated Damages Clause

The other way to circumvent section 75 is not to include any liquidated damages clause in the contract. The innocent party can still claim general damages under section 74 when the contractors delay in completion. In this situation, the plaintiff is still required to prove actual losses, but the amount of damages entitled is not subject to any ceiling amount, as in the case of section 75.

The CIDB Standard form has adopted similar approach by providing a liquidated damages clause and a catch-all provision to preserve the rights to other damages at law if the right to the liquidated damages failed.[161]

[161] Clause 26.2 provides: Upon the receipt of a Certificate of Non-completion the Employer shall be entitled to recover from the Contractor liquidated damages calculated at the rate stated in the Appendix for the period from the Time for Completion or any extended Time for Completion where applicable to the Date of Practical Completion, and may deduct such Liquidated Damages, whether in whole or in part, from any payment due or to become due to the Contractor under the Contract
Clause 26.3 provides: In the event that the Employer for whatever reason shall not be entitled at law to recover Liquidated Damages, the Employer shall remain entitled to recover such loss, expense, costs or damages as he would have been entitled at law.

CHAPTER 6

CONCLUSION

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Construction projects are complex and they involve multi-layer and complicated contractual relationships. Time is always an important factor as any delay in completing the work will expose both parties to serious financial consequences. The risk is even higher for contractors as the standard forms of construction contract provide for many types of breaches that expose contractors to potential damages payable to their Employer.

One of the controversial areas is to determine when a construction project is completed for a liquidated damages clause to be inoperative. The term 'practical completion' has been used widely in most standard form of construction contracts; however, it is unfortunate that there is still no firm legally defined meaning. The courts have over the years adopted different judicial views in defining the expression, but there is no single view that has been universally accepted by all the courts. This has undoubtedly created uncertainty as the rights or liabilities to liquidated damages depend largely on which judicial approach taken by the judge at the hearing. In Malaysia, some standard forms of construction contracts such as PAM 2006 and CIDB do provide for some form of definitions for the term. However, such uncertainty will persist where no definition is given in the contract.

For Employers, one of the ways to ensure that their projects can be completed on time is to incorporate a liquidated damages clause in the contract. This will serve as a whip to monitor the progress of the contractor's work. Under the common law, whenever a

liquidated damages clause is stipulated in the contract, the court has to determine whether such a clause is a genuine pre-estimate of the loss, which is enforceable, or being *in terrorem*, which is unenforceable. The distinction between these two is not clear and cannot be easily done. The court, in general, inclined to enforce a liquidated damages clause, as it is mutually agreed by the parties, unless it is extravagant or unconscionable, in which case the provision will be struck down and the injured party has to prove his actual losses.

While liquidated damages are recognized as valid in most common law jurisdiction, they are invalid in Malaysia by the operation of section 75 of the Contracts Act 1950. The rule of the recovery of liquidated damages is now governed by the strict interpretation of section 75 by the Federal Court in the case of *Selva Kumar* where it was held that an Employer is not allowed to recover the liquidated damages provided for in the contract simpliciter and he needs to prove the actual loss suffered. This decision effectively defeats the very purpose of incorporating the liquidated damages provision in the contract as the inclusion was meant to negate the requirement on the part of the employer to prove the actual loss suffered due to delayed completion by the contractor.

Therefore, this ruling has created hardship for those in the construction industry, and in particular, the employers, where proof of actual loss is often difficult, costly and time consuming. Attempts to circumvent the effect of *Selva Kumar* have thus been made at two levels, by the courts and by the contracting parties themselves.

In the courts level, some recent decisions seem to suggest the continued relevance of liquidated damages clause to the construction industry. The courts have either distinguished the facts of the case from *Selva Kumar* or held that delays in construction

projects are a species of breach for which 'no known measure of damages are employable' with the result that the court is to award reasonable compensation.

It is submitted that the courts ought to give effect to the terms agreed mutually by the parties at the time of entering into the agreement. This will provide certainty to commercial contracts; bearing in mind that certainty is the cornerstone of all commercial activities. In addition, the liquidated damages clause was mutually agreed and by the doctrine of freedom of contract and sanctity of contract, the said clause should and ought to be given the effect that was intended to be. If a party tries to evade term agreed earlier because it is unfavorable to him, then he will be unjustly enriched if the court does not enforce the agreed liquidated damages clause.

In view of the above difficulty, contracting parties have tried to circumvent the rigor of *Selva Kumar* by contracting out of section 75 so as to avoid the requirement of proving actual losses. One such example is clause 22 of PAM 98. Whilst such attempt appears sound, it remains to be seen whether such amendments could withstand judicial scrutiny in Malaysia.

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